

Archived Information



U.S. Department of Education
Fiscal Year 2001
Accountability Report



THE SECRETARY OF EDUCATION
WASHINGTON, D.C. 20202

February 27, 2002

Dear Colleagues in Education:

Americans consistently rank education as a top national priority. They rightly expect the U.S. Department of Education, in partnership with states, communities, institutions, and other Federal agencies, to carry out its responsibilities to effectively and efficiently support educational excellence and equity for all children.

President Bush has made it clear that "no child in America will be left behind." He sees the urgency involved in making our classrooms safer, in boosting achievement in reading and math, and in closing the achievement gaps that exist between minority students and their peers.

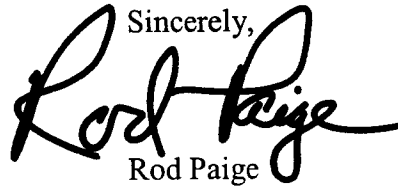
The President unveiled his own legislative package for education reform during his first week in office. Less than a year later, President Bush signed into law the No Child Left Behind Act -- the most sweeping reform of federal education policy in a generation. The legislation, which closely follows the President's agenda to improve America's public schools, passed Congress with overwhelming bipartisan majorities.

The Act provides for accountability for results by requiring strong standards in each state for what every child should know and learn in reading and math in grades three through eight. Student progress will be measured for every child, every year. Schools that fail to make progress will face consequences, and children trapped in failing schools will be given other alternatives. In exchange for this increased accountability, it provides new flexibility for all 50 states and every local school district in America in the use of federal education funds. It focuses educational dollars on proven, research-based approaches that will most help children to learn.

As we move to increase accountability for results in our nation's schools, we must also achieve a culture of "accountability for results" within the Department of Education. To overcome problems that have plagued the Department for far too long, I chartered a Management Improvement Team of senior career managers to address management problems. The Team developed a "Blueprint for Management Excellence" at the Department that included recommended actions for improvement. This blueprint is closely aligned with the President's Management Agenda. We are hopeful that these improvements will lead to the Department of Education's being recognized as a model for management excellence.

Page 2 - Dear Colleagues in Education

There is every reason to be enthusiastic about the future. Together with the President and with the Congress, we can make education reform the law of the land. I will work with the men and women who have dedicated themselves to the Department of Education and to students across the country to empower states, school districts, schools and parents in order that we may serve the needs of our students. When each and every child in this country can receive a quality public education we will have made history together.

Sincerely,

Rod Paige



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

February 26, 2002

Dear Colleagues in Education:

FY 2001 saw the Department move closer to its goal of receiving an unqualified audit or "clean" opinion. Over the last year, we worked diligently to implement recommendations designed to correct deficiencies reported in prior financial audits and assist in the financial management of the Department. Major achievements during FY 2001 included the updating of our continuity of operations plan and the successful implementation and testing of a comprehensive disaster recovery plan for our core financial system. The Department continued its commitment to strengthen internal controls over its daily operations by enhancing policies and procedures and providing additional employee training. The Department also took steps to strengthen information system controls during FY 2001. As a result of these continuing efforts, we have been able to close out 152 of the 160 recommendations included in financial audits dating back to 1995.

Although not in place for the production of the FY 2001 financial statements, the Department successfully implemented Oracle Federal Financials on January 22, 2002. This is the first fully operational Department-wide implementation of Oracle Federal Financials for a cabinet level agency. This implementation represents a significant milestone towards meeting the Department's objectives for improved financial management, reporting and accountability.

Many challenges remain in our continuous effort to improve financial management. Our self-assessment required under the Federal Managers' Financial Integrity Act, the internal control report from our auditors, and the Department's Blueprint for Management Excellence identify a number of weaknesses in financial and other management controls. We are committed to their correction. The Office of the Chief Financial Officer has established its own Management Improvement Team to facilitate the implementation of the recommendations and move toward an "accountability for results" culture.

The attached report describes the Department of Education - our history, mission, priorities and progress. The report highlights our major program and financial accomplishments and describes our future efforts to improve service to our customers. It includes a discussion of the Department's Strategic Plan goals, objectives and results. It contains the results of the Department-wide audit, and the auditor's reports. Finally, this report includes other reporting requirements on financial management: the overall condition of management controls, a progress report on audit follow-up, and a status report on the timeliness of the Department's vendor payments.

The Department recognizes the importance of public disclosure and accountability. This report is a demonstration of our commitment to fulfill our fiduciary responsibilities to the American taxpayer.

Sincerely,

Mark Carney

Deputy Chief Financial Officer

Management Discussion and Analysis

Introduction

The Department of Education is pleased to present the FY2001 Annual Accountability Report. This report is submitted in response to various statutory requirements, including the Government Management Reform Act of 1994 (GMRA). In accordance with the Reports Consolidation Act of 2000, it includes information on the Department's internal controls and reports required under the Federal Manager's Financial Integrity Act (FMFIA). Further included are the Department's financial statements prepared in conformity with Office of Management and Budget Bulletins No. 97-01 and 01-09 as applicable.

"If our country fails in its responsibility to educate every child, we're likely to fail in many areas. But if we succeed in educating our youth, many other successes will follow throughout the country and in the lives of our citizens"

President George W. Bush

Mission

Education is an American priority. The American people are constantly examining how education is organized, structured, delivered and assessed in order to improve quality and ensure equal access to all. While education is primarily a state and local community responsibility, private organizations and federal entities play an important role in improving education.

Within this context, the U.S. Department of Education carries out its mission in two major ways. First, the Secretary and the Department provide leadership responsibility in the ongoing dialogue over how to improve the results of our education system. Second, the Department pursues its goals of access and excellence through the administration of programs covering all areas of education from preschool to postdoctoral research.

In accordance with Government Performance and Results Act (GPRA) results-oriented management, the Department utilizes strategic planning and performance reporting. The Department's mission statement is the guiding standard that gives direction to all goals and objectives of the plan and hence, all activities of the Department. The Department's mission is:

***to ensure equal access to education
and promote educational excellence
throughout the Nation***

Organization

The Department is headquartered, with most of its operations, in Washington D.C. Additionally, about one third of the Department's employees are stationed in ten regional offices and 11 field offices,

making it easier to serve state and local educational systems. The organizational chart, which follows on the next page, shows the structure that supports the day-to-day work.

Goals

Part I of this report illustrates how the Department pursues its mission of ensuring equal access and promoting excellence by focusing its activities on the following six basic strategic goals extracted from the Department's Strategic Plan currently under development:

- 1. Create a culture of achievement**
- 2. Improve student achievement**
- 3. Develop safe schools and strong character**
- 4. Transform education into an evidence-based field**
- 5. Enhance the quality of and access to postsecondary and adult education**
- 6. Establish management excellence**

Specifically, Part I presents the goals and objectives developed during FY 2001 along with selected indicators. When appropriate, this report will also include other descriptive information aimed at providing a richer and more complete picture of the initiatives and programs supported by the Department. Additionally, in compliance with FMFIA, it identifies major management challenges and describes ED's progress toward their resolution.

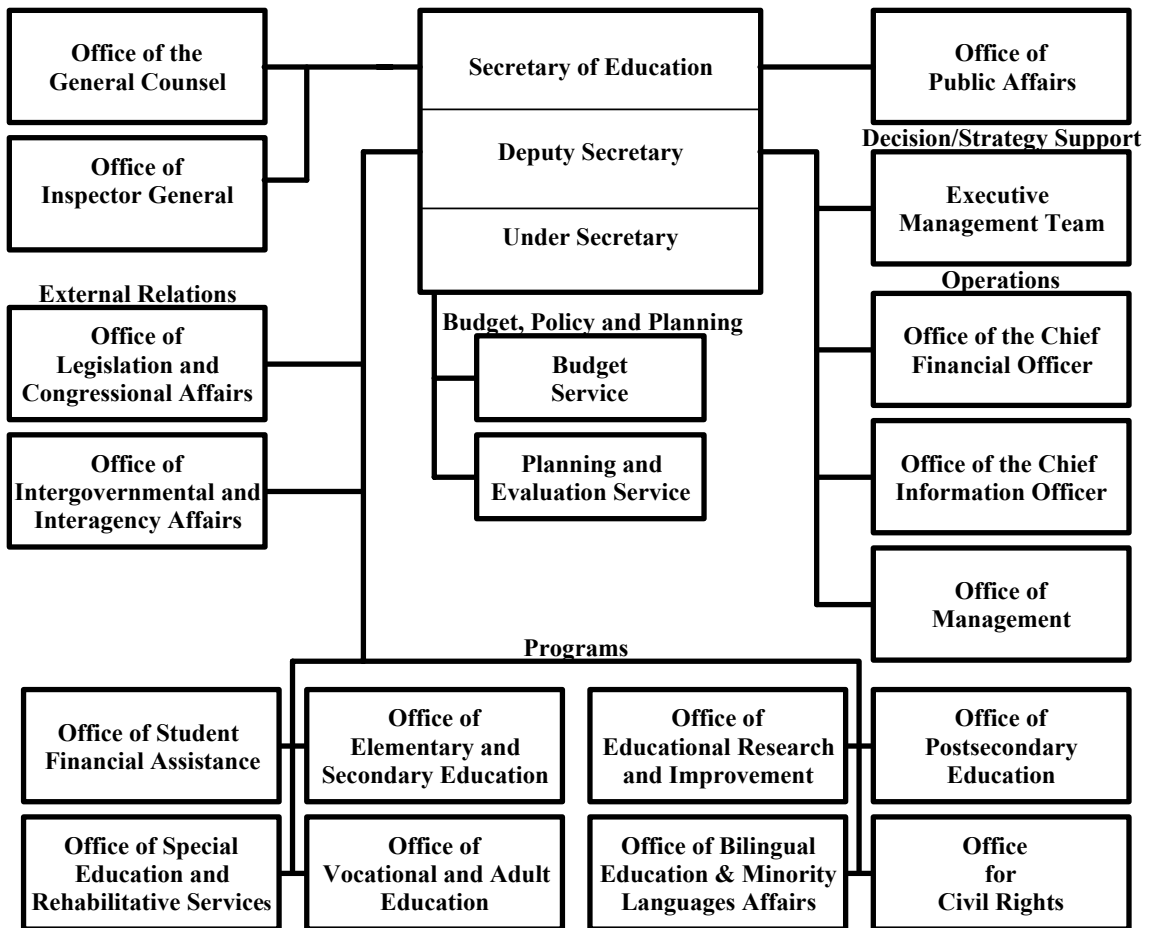
Part II of the report describes the Department's financial performance during fiscal year 2001. It includes the Department's 2001 consolidated financial statements and the reports of the independent auditor.

The reports includes the following two appendices: (A) a glossary of abbreviations and acronyms used in this report, and (B) a list of the Department of Education offices' web sites.

High performance will become a way of life that defines the culture of federal service.

President's Management Agenda for FY 2002

U.S. Department of Education



PART I
Goals and Objectives

Highlights of Reporting Requirements

Management Challenges of the Department
of Education

Limitations of the Financial Statements

Goal 1

Create a culture of achievement

Create a culture of educational excellence by effectively implementing the President's plan, No Child Left Behind

As America enters the 21st century full of hope and promises, too many of our neediest students are left behind. Today, nearly 70 percent of inner city fourth graders are unable to read at a basic level on national reading tests. Our high school seniors trail students in developing nations on international math tests. And nearly a third of our college freshmen find they must take a remedial course before they are able to begin regular college level courses. While education is primarily a state and local responsibility, the federal government needs to do more to reward success and sanction failure of our education system.

Individuals and groups who work in social systems like the American education system are strongly influenced by the system's culture. To achieve improvements in such a system, the most potent strategy for change is cultural change. As part of this effort, we have identified several areas that must be addressed in order to build a solid foundation of learning for all children. Specifically, we have identified the following four principles and will embed these principles in programs and activities throughout the Department:

- **Link federal education funding to accountability for results**
- **Increase flexibility and local control**
- **Increase information and options for parents**
- **Encourage the use of scientifically based methods within federal education programs**

In order to create a culture of achievement, we must demonstrate that achievement counts. Formula-based grants will become performance based, awarding bonuses to States for significant progress and imposing sanctions for lack of results. With Federal support, States will develop systems that hold all educational institutions accountable for results. Demonstration programs in areas of national significance will be supported, but discretionary programs that do not demonstrate results in terms of student outcomes will be recommended for consolidation.

In return for accountability, States, school districts, and other grantees will receive increased flexibility over the use of Federal funds. Department-wide information technology initiatives will dramatically reduce the paperwork burden on State and local officials by seamlessly collecting and disseminating performance information. States will publish report cards that provide school performance information to parents. Children trapped in persistently failing schools will have the

opportunity to attend better public schools or use Federal funds for private tutoring. Public school options, including charter schools, will be strongly supported.

Goal 2

Improve Student Achievement

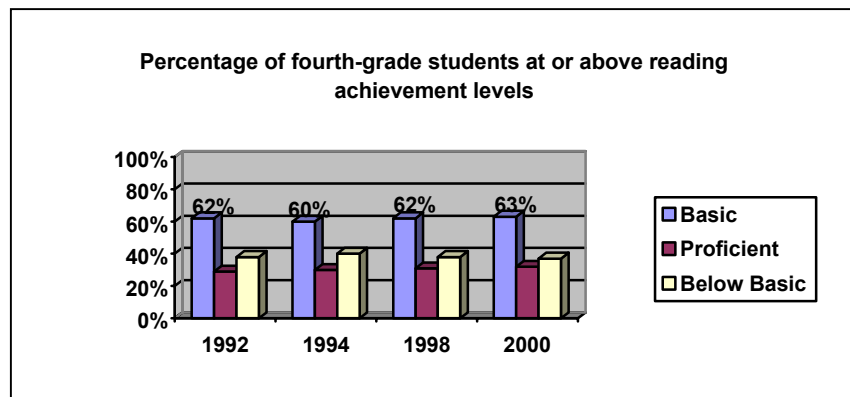
Improve achievement for all groups of students by putting reading first, expanding high quality math and science teaching, and boosting teacher quality

In education, the bottom line is student learning. As a result of the Department's efforts under this plan, American students will improve their achievement in reading, math and science sufficiently to make choices about their future work or study, and to participate fully in citizenship of the United States. The U.S. Department of Education will lead a national campaign to ensure that every child is taught to read at grade level by third grade. Pre-school and elementary school teachers throughout the nation will have access to training in the proven components of effective early reading instruction. To ensure that students become proficient in mathematics and science, the Department will establish a broad collaboration of school districts, colleges and universities, and research institutions to improve the quality of instruction in those areas. Since the quality of instruction is dependent upon the development of well-prepared teachers, the Department will establish initiatives to ensure that supply meets demand. Here are the Department's objectives for this goal:

- **Ensure that all students read on grade level by the third grade**
- **Improve math and science achievement for all students**
- **Improve the performance of all high school students**
- **Improve teacher and principal quality**

Reading

Reading is the foundation of all other skills essential for learning, yet the National Assessment of Educational Progress (NAEP) reports that only 63 percent of all fourth-graders read at the basic level or higher.



"We know that children who have poor beginning reading skills are less likely to develop reading skills throughout their school careers. Children, who start school behind, often stay behind. We can reverse that trend."

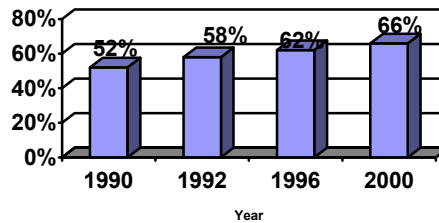
First Lady Laura Bush

Research shows that students who fail to read well by fourth grade are at greater risk of educational failure. Mastering basic skills such as reading are essential first steps to reaching challenging academic standards. Since the 1970's, NAEP scores for fourth-graders have been relatively flat (around 60 percent at basic or higher levels). These statistics are disturbing because they indicate that around 40 percent of the fourth-grade population continues to have difficulty reading at the basic level. The Department will strive to ensure that every child must read on grade level by the end of third grade. To reach that goal we will ensure that reading instruction is based on solid research.

Mathematics

To be prepared for postsecondary study and promising careers, students need to master advanced skills in mathematics, science and technology. Mathematics also teaches ways of thinking that apply in the workplace and are essential for informed civic participation. A report released in August 2001, by the National Center for Education Statistics (NCES)

Eighth Grade Performance in Mathematics
 Percentage of Eighth Grade Students who Perform at or above Basic on NAEP



shows improvement for U.S. students in mathematics. Scores for students in fourth and eighth grade indicate continued progress over the last ten years. The percentage of eighth-graders at or above Basic increased from 52 percent in 1990 to 66 percent in 2000. However, the U.S. Commission on National Security/21st Century reported that the nation's mediocre math and science performance is one of our major national security liabilities.

Goal 3

Develop safe schools and strong character

Establish safe and disciplined educational environments that foster the development of good character and citizenship

September 11th has created a new environment in which we must ensure that our children are safe from threats from without as well as within; we will work to maintain a safe and drug-free environment in which they can learn. In addition, as the President said on his campaign, "Teaching

“First, we must do everything in our power to ensure the safety of our children.”

President George W. Bush

is more than training, and learning is more than literacy. Our children must be educated in reading and writing—but also in right and wrong.” He quoted Dr. Martin Luther King, Jr., who said, “Intelligence plus character—that is the true goal of education.” We will focus the nation’s education system on our children’s hearts, as well as their minds. Here are the Department’s objectives for this goal:

- **Ensure that our nation’s schools are safe and drug-free and that students are free of alcohol, tobacco and other drugs**
- **Promote strong character and citizenship among our nation’s youth**

The Department will sponsor research initiatives to develop a better understanding of the causes of student violence, and it will work with law enforcement departments to remove barriers to information sharing. In addition, states will be supported in their efforts to provide greater parental choice of schools to ensure that students are not forced to attend persistently dangerous schools.

Goal 4

Transform education into an evidence-based field

Strengthen the quality of educational research

For too long, the education field has been subject to fads and fancies, much like the pre-scientific era of medicine. We will change the culture of education into one that values evidence over ideology. We will do our part by dramatically improving the quality of research funded or published by the Department, and by providing policymakers, educators, parents, and other stakeholders ready access to high quality, easy-to-understand research. Here are the objectives for this goal:

- **Raise the quality of research funded or conducted by the Department of Education**
- **Increase the relevance of our research in order to meet the needs of our research customers**

The U.S. Department of Education is one of the primary sources of funding for educational research. Thus, we have an opportunity and a responsibility to ensure that the research funded or published by the Department is of the highest quality. We will develop and enforce rigorous standards, will rejuvenate the peer review process, and will bring focus to the Department’s research activities.

Goal 5

Enhance the quality of and access to postsecondary and adult education

Increase opportunities for students and the productivity of institutions.

The Department of Education recognizes that the productivity of our nation is dependent upon the quality of the postsecondary education opportunities made available to the American people. Besides helping to ensure access to postsecondary training for our young people, it is also essential that we encourage lifelong learning, whether it is graduate school or adult basic education, advanced technical training or training in job entry skills. This includes many for whom lifelong learning opportunities are of special importance, such as persons with disabilities, adults lacking basic skills, and those whose job skills need upgrading or who require retraining because of labor market changes.

To help guarantee access to postsecondary education and lifelong learning, the Department has set the following objectives for this goal:

- **Reduce the gaps in college access and completion among student populations differing by race/ethnicity, socioeconomic status, and disability while increasing the educational attainment of all**
- **Strengthen accountability of postsecondary institutions**
- **Establish effective funding mechanisms for postsecondary education**
- **Strengthen Historically Black Colleges and Universities, Hispanic Servicing Institutions, and Tribal Colleges and Universities**
- **Enhance the literacy skills of American adults**

The single largest category of investment the Department makes with the federal education dollar is in postsecondary education - helping families pay for college.

The history of federal financial assistance to college students goes back to the GI Bill of 1944, which served as the springboard to the middle class for millions of American servicemen and their families. Today, the federal government funds a large percentage of all student financial aid in the nation. The major programs supporting Goal 5 are described below.

The **Pell Grant Program** helps ensure financial access to postsecondary education by providing grant aid to low and middle-income undergraduate students. The most need-focused of the Department's student aid program, Pell Grant awards, vary in proportion to the financial circumstances of students and their families. During fiscal year 2001, almost 4 million students received grants averaging \$2,311.

Two major student loan programs account for most of the remainder of the Department's support for postsecondary education. The **Federal Direct Loan Program** lends funds directly to college students. The U.S. Treasury provides loan funds for the Direct Loan Program. The **Federal Family Education Loan (FFEL) Program** makes federally guaranteed loans available to students through private lenders.

The Department's **Campus Based** programs provide assistance to institutions, which enable them to provide students with employment, grants and low interest rate loans on the basis of need. **Higher Education** programs provide institutional support, student services, quality reforms and improvements to help minority and other disadvantaged students prepare for and succeed in college.

The total portfolio of postsecondary aid programs run by the Department generated \$61 billion in student aid (including Federal Family Education Loan capital, Perkins Loan capital from institutional revolving funds, and institutional and state matching funds) to more than 8.1 million postsecondary students and their families during FY 2001.

During FY 2001, the Department of Education worked with over 6,000 postsecondary institutions, 4,000 lenders, and 36 guaranty agencies to deliver grant, loan and work-study assistance to students who rely on federal student aid to pay for college.

The Department has identified the modernization of the student aid delivery system as one of the highest priority management objectives. This modernization is managed by a performance-based organization (PBO), Student Financial Assistance (SFA). The PBO's operations are shaped by a five-year performance plan.

SFA's 2001 Performance Plan included an ambitious list of 86 operating goals and improvement projects. The Plan features an e-commerce strategy with products and services for students, schools and financial partners. SFA has published brochures covering a sweeping spectrum of information for students - from finding affordable ways to search for scholarships and apply for federal student aid, to Spanish versions of *The Student Guide*, *Funding Your Education* and the 2001-02 drug brochure. A Web portal for schools consolidates many SFA school services onto one master Web page and provides real-time information that will enable financial aid professionals to respond more quickly, accurately and productively. In May 2001, the first release of the Financial Partners data mart was unveiled that provides access to historical information from the FFEL system. Subsequent releases will provide for links with other systems, expand the amount of data which can be accessed and allow guaranty agencies and other SFA divisions access to FFEL financial information needed for reviews and technical assistance.

“The purpose of prosperity is to make sure the American dream touches every willing heart. The purpose is to leave no one out – to leave no child behind.”

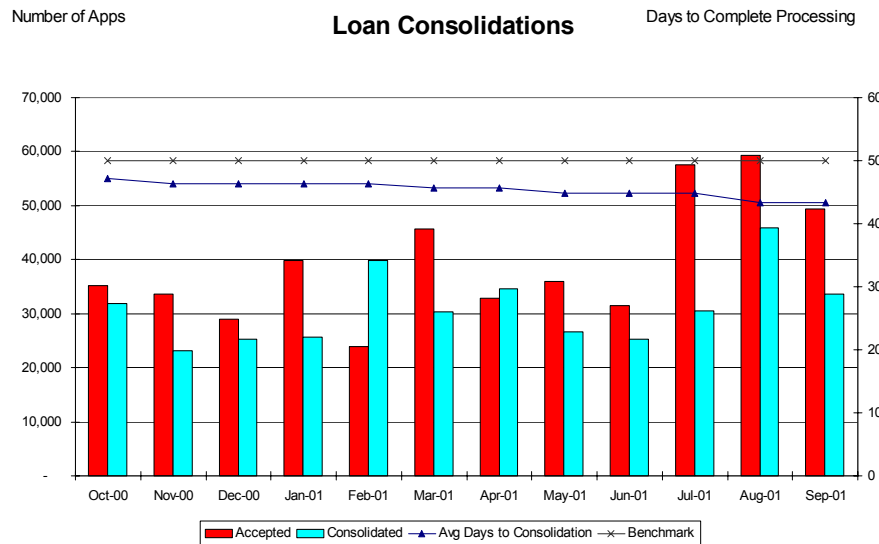
President George W. Bush

However, the plan doesn't cover the fundamental set of values that employees bring to their jobs. These values -- be worthy of trust, be courteous, deliver great products and services and be efficient -- are the basis for prioritizing day-to-day decisions, especially when things don't go according to plan. These values are exhibited in SFA's success of the past years, as noted by its receipt of numerous prestigious awards -- the 2001 Federal Acquisition Award, the 2001 Digital Government Award and the 2001 Pioneer and Explorer Awards -- the highest and second-highest awards given by *E-Gov*.

The following performance measures highlight the progress being made in meeting SFA performance plan goals.

Customer Satisfaction - Process Loan Consolidations in 50 days or less

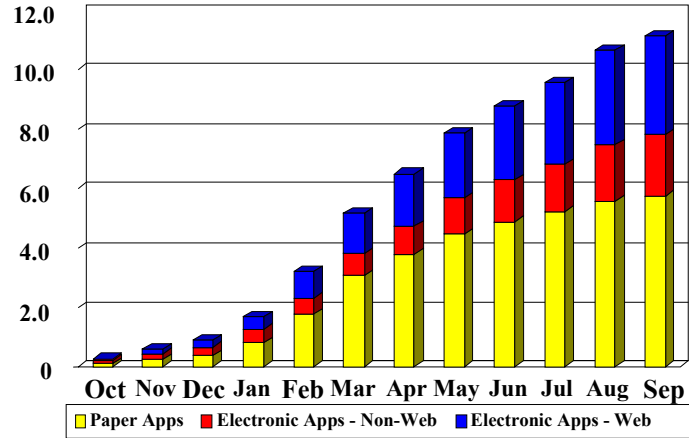
SFA consolidated and completed processing of 366,970 loans in FY 2001 with an average turnaround time less than its goal of 50 days or



less. Loan consolidators have exceeded the established timeframes and are currently averaging 42 days for processing consolidations. For FY 2001, the goal of 150,000 applications filed electronically was exceeded, with over 347,854 electronic applications being received.

Customer Satisfaction - Increase the number of Free Applications for Federal Student Aid (FAFSAs) filed electronically from four million in FY 2000 to five million in FY 2001.

FAFSAs Processed in Fiscal Year 2001



SFA met its goal of receiving 5 million electronic FAFSAs by the end of fiscal year 2001. The electronic application is faster and easier for the students to file and for the Department to process. Of 11.1 million applications processed in FY 2001, 5.36 million were filed electronically. SFA was a recipient of the E-Gov Explorer Award for its web-based FAFSA.

Customer Satisfaction - Provide, via Direct Loans Servicing Website, new Spanish Language Deferment and Forbearance request.

With implementation of the website <http://www.dlservicer.ed.gov/> in February 2001, SFA increased E-commerce for the Spanish-speaking borrower. Spanish-speaking borrowers were able to access and download deferment and forbearance forms in Spanish. A borrower now has the ability to toggle between English and Spanish interfaces. SFA was a recipient of the Digital Government Award for the Direct Loans Servicing Website - chosen for top honors from 100 nominations.

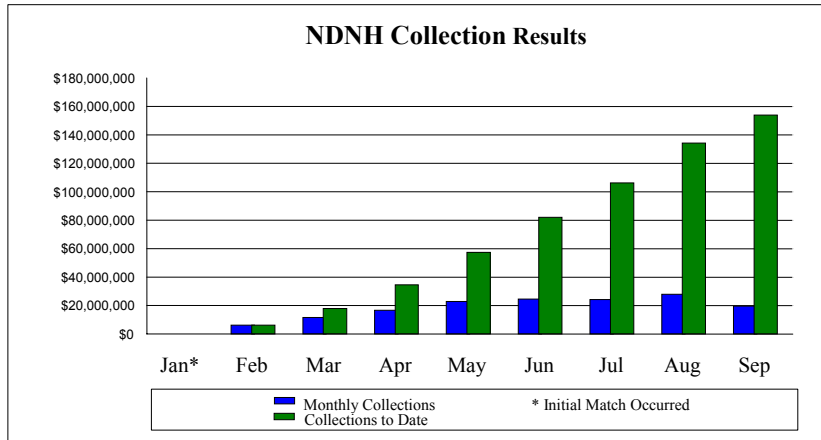
Reduce Costs - Increase to 400,000 the total number of borrowers repaying direct loans through electronic debiting

The Electronic Debit Account (EDA) provides an efficient means of payment, generates savings to SFA processing costs by electronically debiting borrowers and provides a more consistent payment flow in an error free environment. The EDA provides the borrower with an efficient means of payment that eliminates the need for check writing, mailing and postage. The total number of borrowers using Electronic

Debiting increased from 261,236 at the beginning of FY 2001 to 424,209 at the end of the fiscal year. This exceeds the goal of 400,000. More significantly, this increase of EDA users eliminated the need to mail 3,589,630 bills, resulting in direct cost savings of \$1,196,414 in FY 2001.

Reduce Costs - Implement the National Directory of New Hires database matching program.

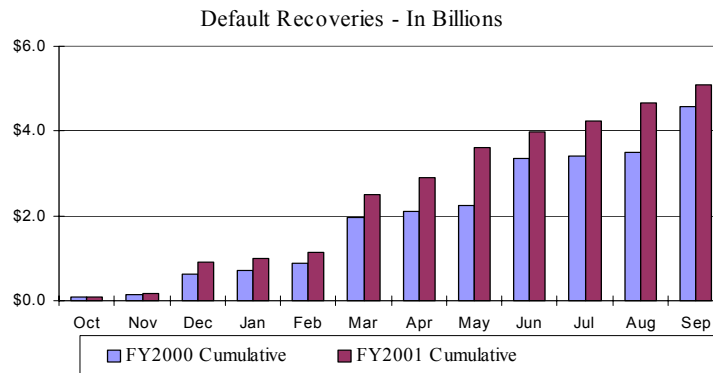
In FY 2001, SFA collected over \$150 million as a result of matching SFA collection records against the National Directory of New Hires (NDNH) database, a database operated by the Office of Child



Support Enforcement of the Department of Health and Human Services (HHS). Since matching efforts with HHS began in January 2001, new information has been obtained on 890,621 accounts with unpaid loan balances totaling \$3.2 billion. Quarterly matches are planned for FY 2002, to include all guaranty agencies and eligible ED accounts.

Reduce Costs - Keep the Default Recovery Rate at 10% or higher.

The combined ED and Guaranty Agency (GA) collections on defaulted loans totaled \$5.121 billion for FY 2001 -- \$1.403 billion in ED

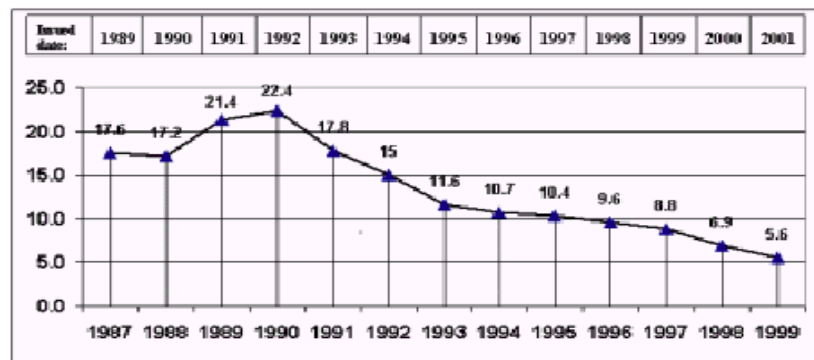


recoveries and \$3.718 billion with the guaranty agencies. The collections resulted in annual recoveries of 17.7 percent¹ of the outstanding portfolio. SFA exceeded its collections goal of 10 percent of its outstanding portfolio. The commission paid (as a percentage of recoveries) to our private collection agencies has dropped from 18.1 percent in FY 2000 to 16.9 percent in FY 2001. The decreased percentage has resulted in direct cost savings in excess of \$9.3 million.

Reduce Costs - Keep the Cohort Default Rate Under 8%

Under statute, a key measure of student loan defaults is the "cohort default rate," which is the percentage of borrowers that entered into repayment on FFEL and Direct Loan Program loans during one fiscal year and defaulted on those loans in the same fiscal year that they entered repayment or the following fiscal year.

Because of concerns about high default rates and inadequate loan collection in the student aid programs, Congress and the Department have taken actions to reduce defaults - including management reforms and increased attention to assist at-risk postsecondary institutions. This has allowed the Department to cut the default rate by 75 percent - from 22.4 percent in FY 1990 to 5.6 percent in FY 1999 (the most recent cohort default rate data available).



¹ The recovery rate is comprised of the sum of ED's collections and the guaranty agency's (GA) collection on defaulted loans divided by the outstanding portfolio at the end of the previous year. At the end of FY 00, the outstanding portfolio was \$28.8 billion reflecting approximately \$12 billion with ED and \$16.8 billion with the guaranty agencies.

Goal 6

Establish Management Excellence throughout the Department of Education

When the Secretary of Education, Rod Paige, arrived at the Department, he found financial and management problems that over the course of several years had damaged the Department's credibility on Capitol Hill and with the American public. Auditors had been unable to issue a clean opinion on the Department's financial statements for each of the prior three years; the student financial assistance programs remained a fixture of the General Accounting Office's (GAO's) High-Risk List; and information technology security and management needed improvement. GAO and the Department's Office of the Inspector General (OIG) had repeatedly documented problems with respect to Department management. Auditors also had identified several areas within the Department susceptible to fraud and abuse. Secretary Paige decided that the Department of Education needed to strengthen its management in order to fulfill President Bush's goals for America's schools and students. He demanded a solid foundation of excellent management to enable the Department to perform its mission more effectively.

In April 2001, Secretary Paige took quick and decisive action to address longstanding management problems. He tasked a "SWAT" team of senior career managers -- called the Management Improvement Team (MIT) -- to develop a blueprint for management excellence at the Department.

Secretary Paige then directed the MIT to formulate a strategy to:

- make accountability for results the primary operating principle for all Department employees, grantees, and contractors;
- obtain a clean audit opinion from the Department's auditors;
- remove the Student Financial Assistance (SFA) programs from the GAO High Risk List;
- put in place an effective system of internal controls to protect the Department's assets from waste, fraud and abuse;
- further modernize student aid delivery and management to continue reducing student loan default cost and use Internal Revenue Service data for income verification; and
- measure progress toward solving these problems.

The Blueprint for Management Excellence describes how the Department will achieve the Secretary's vision to establish the U.S. Department of Education as the benchmark for accountability and performance by which all other Federal agencies and State and local education systems will be measured. The Blueprint embraces GAO guidance with specific actions addressing GAO concerns.

The Management Improvement Team (MIT)

The MIT established a process to identify, catalogue and track actions to correct management weaknesses identified as of April 1, 2001. The MIT identified, prioritized and tracked the progress toward resolution of hundreds of recommendations for management improvements. These recommendations came from reports issued by the Department's auditors, GAO and OIG, other internal reviews and the Student Financial Assistance (SFA) Performance Plan. The MIT worked with Principal Offices to facilitate and monitor the completions of actions and it made every effort to determine the steps necessary to satisfy the auditors' concerns. The MIT has also taken steps to ensure that this process continues after the MIT's initial work is completed.

To be effective, management reforms also require the support of Department employees and the public, including that of their elected representatives in Congress. The MIT worked with the Department's financial statement auditors and the OIG to determine specific action steps and structure for addressing issues raised in previous financial statement audits. The Department's senior leadership worked closely with Congress, GAO and the Office of Management and Budget (OMB) to update them on the Department's actions and to obtain their guidance concerning future activities. Senior leadership also implemented an awareness campaign to inform Department of Education employees and the public of management improvements.

To further engage GAO in the Department's management reforms, Secretary Paige and Deputy Secretary Hansen initiated a meeting with the U.S. Comptroller General in July 2001.

The discussion centered on the high-risk status of the student financial assistance programs and related management issues. GAO wrote to Deputy Secretary Hansen on August 1, 2001 offering its guidance for managing student aid risk and for removing the programs from the high-risk list. The *Blueprint* Action Plan includes items that address GAO's requirements.

GAO High-Risk Guidance

- Strengthen Financial Management and Internal Controls
- Implement Integrated Information Systems
- Minimize Noncompliance and Default Rates while Promoting the Programs

August 1, 2001, letter from GAO to the Department

Without accountability, how can we expect results?

President George W. Bush

Vision for the Future

The first step to achieving management excellence is to clarify the Department's appropriate role in education. Through its long-range strategic planning process, the Secretary and his management team are communicating what it means to craft a different, better federal role in education. The *Blueprint* is a next step in this communication process.

The *Blueprint* action items plus the interrelated goals and objectives in the Department's Government Performance and Results Act (GPRA) strategic and annual performance plans will be tracked in one management system. The Secretary will use the action items to hold political and career leaders accountable for results in all areas of the Department's responsibilities. Management excellence means that the Department will be a well-run, well-respected agency. It means that the Department maintains and documents its commitment to accountability. A structure for measuring progress in identifying and solving problems, oversight of the management process, and steps to prevent future management problems are all essential to achieving this vision. Having a solid foundation of excellent management will enable the Department to perform its mission more effectively.

Selected Highlights of the Blueprint for Management Excellence:

The *Blueprint* describes the Department's commitment to management improvement in five distinct areas:

- Developing and Maintaining Financial Integrity and Management and Internal Controls
- Modernizing the Student Financial Assistance Programs and Reducing Their High-Risk Status
- Expanding Strategies for Using Human Capital
- Managing Information Technology Systems to Improve Business and Communications Processes
- Achieving an "Accountability for Results" Culture

The *Blueprint* is a living plan, consisting of a series of actions, that will change as circumstances change and as the Department performs benchmarking with high-performing agencies and business. The Department must implement these actions to accomplish its programmatic goals and create a culture of accountability. The MIT worked with the Department's auditors, the Council for Excellence in Government, OMB, GAO and Department managers and employees to establish this action plan.

Develop and Maintain Financial Integrity and Management and Internal Controls

Financial Integrity means the Department will be assured of accurate and relevant financial reporting systems and processes to provide managers and stakeholders with timely and accurate financial information and reports. It means revenues and expenditures are properly accounted for and reported on. It means that the reports and data produced by these systems and

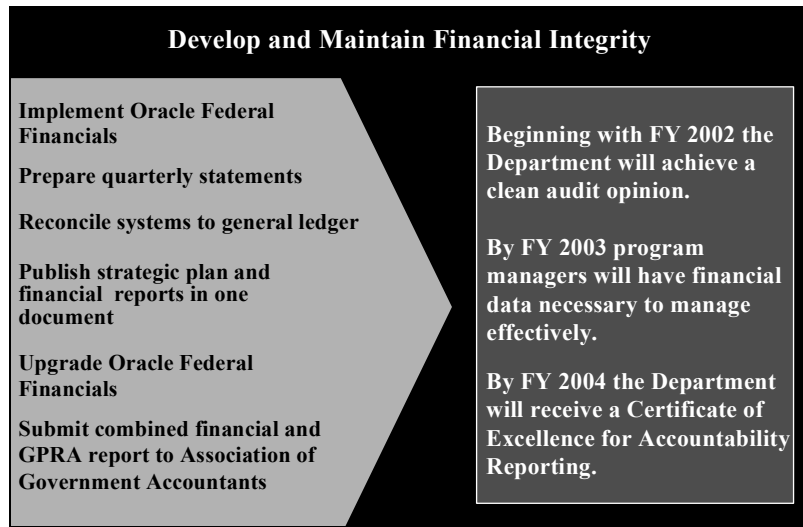
processes will aid managers and stakeholders when making programmatic and asset-related

A clean financial audit is a basic prescription for any well-managed organization. Without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people.

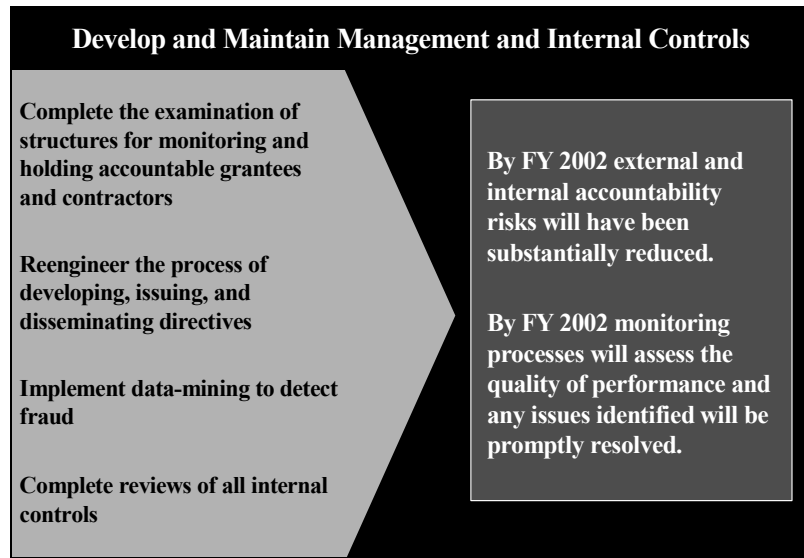
President's Management Agenda for FY 2002

decisions. Financial integrity will result in the Department's auditors concluding that the Department's financial reporting systems produce accurate and reliable data.

The sought-after clean audit opinions from the auditor will affirm that systems and processes are reliable and produce accurate and reliable data that will be useful in education program decision-making.



Management and Internal controls will be adopted and enhanced to reduce risk of errors and permit effective monitoring of programs and processes. Management controls will ensure that the Department's organizational structure, policies and procedures support its programs so that they achieve the intended results. They will ensure that resources are used in a manner consistent with the Department's mission and that programs and resources are protected against waste, fraud and mismanagement.



Modernize the Student Financial Assistance Programs and Reduce Their High-Risk Status.

The Department will improve its financial and management information to manage the student aid programs effectively. It will follow the specific criteria provided by GAO in their August 1, 2001 letter for reducing student aid risk and removing the programs from the high-risk list. It will strengthen financial management and internal controls so that relevant, timely

information is available to manage day-to-day operations and provide accountability. It will integrate

Erroneous payments to students will be reduced, ensuring that aid is targeted to the neediest students and increasing public confidence in the programs' integrity.

President's Management Agenda for FY 2002

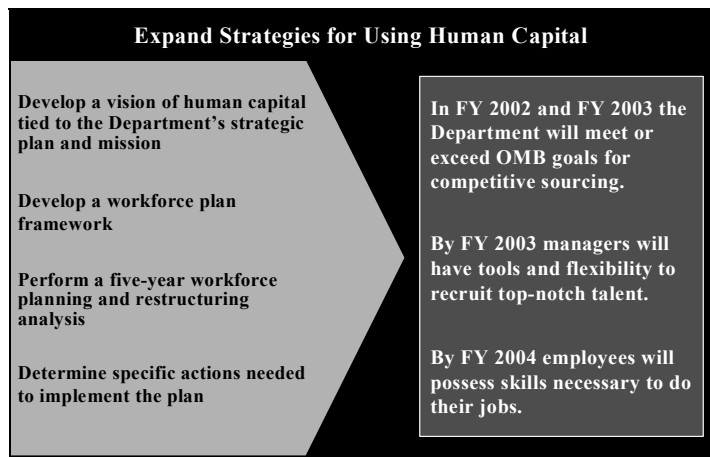
information systems by refocusing the plans in the SFA's *Modernization Blueprint*. These plans reflect strategies for improving service, cutting costs and integrating and improving systems. It will also minimize noncompliance and default rates while promoting widespread program use.

Expand Strategies for Using Human Capital.

The Department will align its functions and organization structure with its primary mission, its long-range strategic plan, and the *Blueprint* to support its culture of accountability. It will streamline operations and bring work closer to its customers—taxpayers, states, school districts and schools. At the center of this reform is the strategic use of human capital. The Department’s human capital strategy will transform the agency by reducing the number of managers, delayering management levels, increasing competitive sourcing, and improving decision-making. Through strategic retention and innovative recruitment, the Department will transform the problem of retirements over the next five years into an opportunity to improve the overall workforce quality. (The *Blueprint* includes action items to guard against the loss of institutional knowledge). The transformed workforce will understand the Department’s mission and will have the tools needed to perform that mission. To recruit top-notch talent, the Department will make full use of all existing authorities, such as repayment of student loans and expedited hiring practices. It will also seek new and innovative human resources authorities to achieve personnel goals. It will implement the administration’s Managerial Flexibility Act. Expanding human capital strategies will result in a high-performing organization that accomplishes its mission effectively and efficiently.

Human capital strategies will be linked to organizational mission, vision, core values, goals, and objectives. Agencies will use strategic workforce planning and flexible tools to recruit, retrain, and reward employees and develop a high-performing workforce. Agencies will determine their “core competencies” and decide whether to build internal capacity or contract for services from the private sector. This will maximize agencies’ flexibility in getting the job done effectively and efficiently.

President’s Management Agenda for FY 2002



Manage Information Technology Systems to Improve Business and Communications Processes.

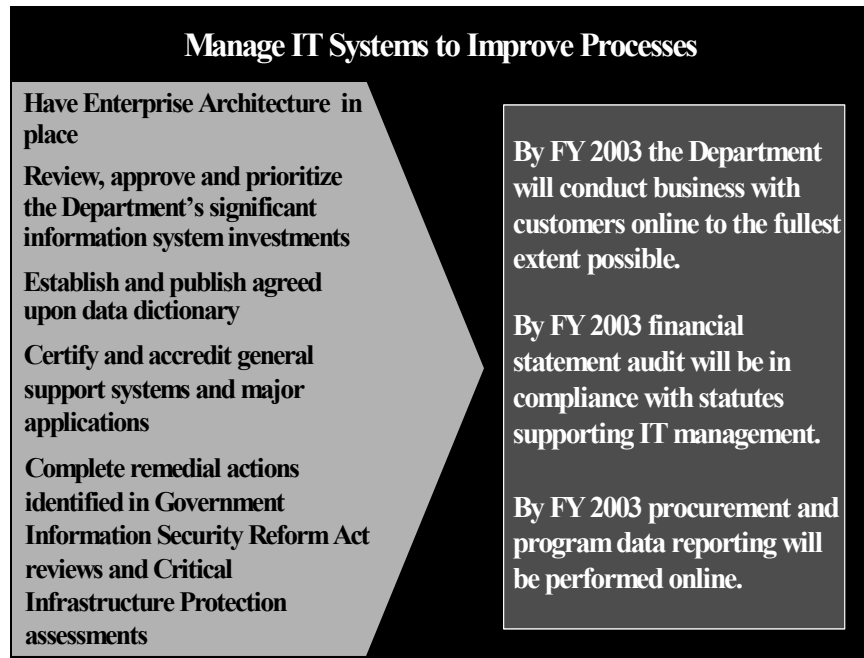
To accomplish the expanded electronic government initiative in the *President's Management Agenda for FY 2002* and meet the business needs of its customers, the Department will effectively manage information

technology (IT). The Department will also provide principal offices, schools and students with information and

services that respond to their business needs and accomplish *Blueprint* and long-range strategic plan goals. The Department will also manage its IT investments, protect the integrity and confidentiality of data, improve its data management and increase the use of technology in serving customers. Finally, the Department will maintain integrated, secure and reliable systems in a changing data-sharing environment and safeguard its assets, including information.

In short, by improving information technology management, simplifying business processes, and unifying information flows across lines of business, agencies will provide high quality customer service regardless of whether the citizen contacts the agency by phone, in person, or on the Web.

President's Management Agenda for FY 2002



Achieve an “Accountability for Results” Culture.

The Department will measure progress and monitor results as it performs its mission. Through the *Blueprint* the recipients of Department funds, Department employees and Department contractors will be held responsible for their performance in relation to the goals and objectives.

They will all understand what is expected of them. The Department will work with grantees and

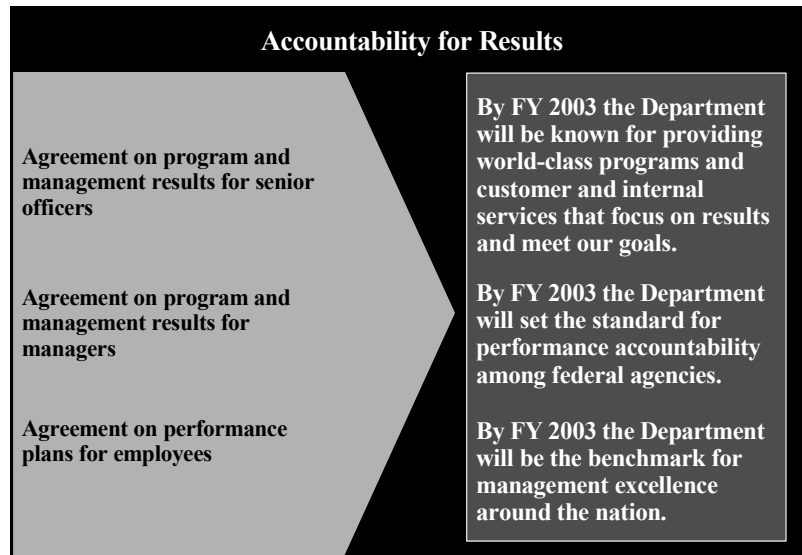
High performance will become a way of life that defines the culture of federal service.

President’s Management Agenda for FY 2002

contractors to develop performance standards that will yield the results called for in the long-range strategic plan. Managers will evaluate their performance, and will reward or participate in corrective actions as necessary based on that performance. All parties will take personal responsibility for achieving their program and administrative goals.

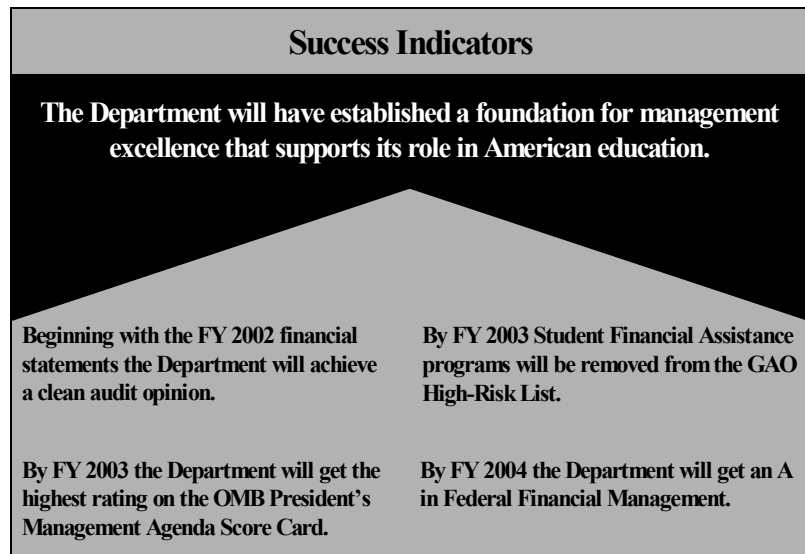
“Accountability” from the employee perspective means that all employees:

- realize how their work contributes to satisfying principal office and agency-wide strategic plans, and positively affects students, educators and citizens;
- will have zero tolerance for fraud or other forms of intentional abuse of public funds, as will contractors, external partners and customers;
- understand agency values, expectations and its code of conduct; and
- assume responsibility for identifying and addressing issues, thus allowing the Department to rely less on external auditors to provide this important service.



Success Indicators

Transforming the Department of Education into a high-performance organization and restoring the public trust will require continuous improvement over an extended time period. By following this *Blueprint* and the detailed action plan, the Department will achieve the following success indicators envisioned by Secretary Paige.



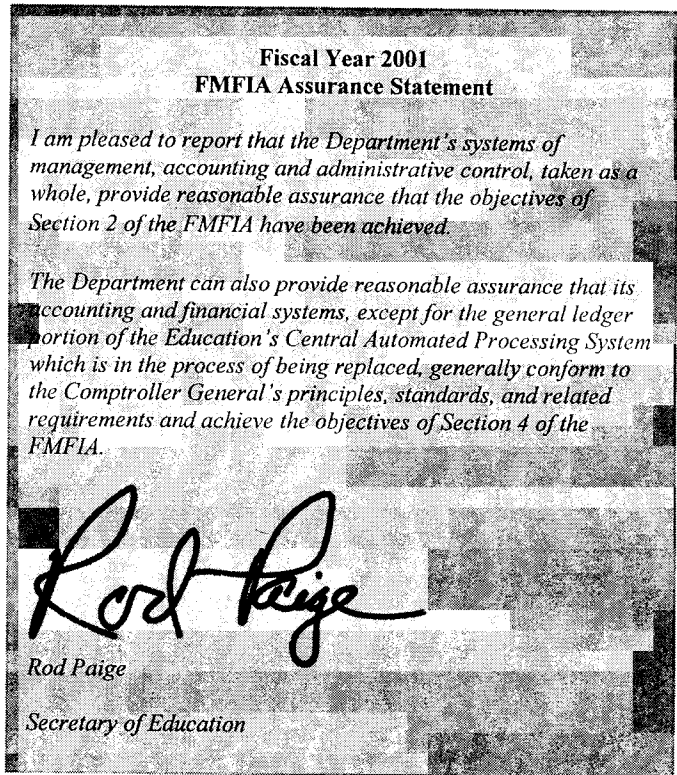
Highlights of Reporting Requirements

Federal Managers' Financial Integrity Act

To protect federal programs from fraud, waste and mismanagement, the Federal Managers' Financial Integrity Act (FMFIA) requires agency managers to conduct regular evaluations of management controls with special attention to accounting systems. FMFIA compliance is embodied in larger efforts to reform management processes at the Department of Education.

While no new material weaknesses or non-conformances were identified in FY 2001, a material weakness – Financial Reconciliation – that in FY 2000 was downgraded because all corrective actions plans had been implemented – has been included again in the FY 2001 FMFIA Section 2, Management Control. This is due to the fact that the FY 2000 financial

statements audit identified additional concerns in this particular area.



FMFIA Section 2, Management Control

Of the 80 internal control material weaknesses identified since the inception of the program, 75 have been corrected and closed, leaving 5 unresolved items as of December 31, 2001.

Number of Material Weaknesses

Period Reported	Number Reported for the first time	For That Year number corrected	For That Year number still pending
Prior Yrs	75	74	1
1999	3	1	2
2000	2	0	2
2001	0	0	0
Total	80	75	5

The unresolved weaknesses were all identified prior to FY 2001. Specifically, the first of these prior years material weaknesses is listed as “Quality of Data Needed to Support Management Decision” and was first reported in 1995. This material weakness deals with the Student Financial Assistance not having quality data to provide for effective management decision-making. While the data quality issues were initially associated with the Federal Family Education Loan (FFEL) Program system, it was expanded to include all SFA systems. ED has completed a considerable number of the planned corrective actions aimed at the resolution of this material weakness. Corrective actions remaining include: 1) secure legislation to allow for data matches with the Department of Treasury; 2) continue data quality efforts to improve timeliness and quality of lender and other FFEL data; and 3) implement the Common Origination and Disbursement (COD) system which will improve the quality of SFA student level information across the SFA systems. This weakness is scheduled to be resolved during FY 2002.

Further, the weakness listed under “IT Security Program” in 2001 has been expanded to include security corrective actions, policies, procedures, reviews, and plans necessary to bring the Department’s IT systems into compliance with the Government Information Security Reform Act (GISRA). The last of the corrective actions for this weakness is scheduled to be completed during FY 2002.

The remaining material weaknesses reported – Foreign School Recertification, Audit Tracking and Resolution Process and Financial Reconciliation - are scheduled to be resolved during FY 2002.

FMFIA Section 4, Management Control

Of the 95 financial management systems non-conformances identified since the beginning of the program two remain unresolved. These two material non-conformances were reported prior to FY 2001.

Number of Material Non-Conformances

Period Reported	Number Reported for the first time	For That Year number corrected	For That Year number still pending
Prior Yrs	95	93	2
1999 Rpt	0	0	0
2000 Rpt	0	0	0
2001 Rpt	0	0	0
Total	95	93	2

The two material non-conformances currently outstanding encompass the following areas: The Federal Family Education Loan System -where the Department did not have a methodology for determining the loan loss of FFEL using validated data. This item was first identified as a material non-conformance in 1990. All but one major milestone to close this

issue has been completed. The completion of the last pending action has been delayed until the Department's new general ledger becomes fully implemented. This is scheduled for completion in the second quarter of FY 2002.

The other area involved is the Department's Financial Management Systems. The Legacy core financial management systems had numerous functional and technological problems. Conversion to a new system, the Education Central Automated Processing System (EDCAPS), was completed during 1998. However, shortcomings of the Financial Management System Software (FMSS) portion prevented ED from preparing timely financial statements. The implementation of the new general ledger system to replace FMSS is scheduled for completion in the second quarter of FY 2002.

Semiannual Report to Congress on Audit Follow-up

As required by the Inspector General Act Amendments of 1988, the Department reports on management actions in response to audit recommendations. Management is required to report on these two areas:

1. Number of Audit Reports and the Dollar Value of Disallowed Costs

Disallowed Costs are questioned costs that management, in a management decision, sustained or agreed should be recovered by the federal government. The information contained in the table represents audit reports for which receivables were established.

Final Actions on Audits with Disallowed Costs

For the Fiscal Year Ended September 30, 2001

	# of Reports	Disallowed Costs
Beginning Balance as of 10/1/00	188	\$ 152,870,062
+ Management Decision	256	28,460,651
Pending Final Action	444	181,330,713
- Final Action	300	26,882,033
Ending Balance as of 9/30/01	144	154,448,680

2. Reports Pending Final Action One Year or More After Issuance of a Management Decision

On September 30, 2001 the Department had a total of 12 OIG internal and nationwide audit reports on which final action was not taken within one year after the issuance of a management decision. Fifty percent of the 12 reports were 1 to 2 years old. Twenty-five percent were 2 to 4 years old. The remaining twenty-five percent were 4 years old. Many corrective actions are dependent upon major system changes that are currently being implemented. For detailed information on these audits, refer to previously issued Semiannual Reports to Congress on Audit Follow-up Numbers 24 and 25.

Prompt Pay

The Prompt Pay Act requires agencies to report on their efforts to pay bills on time. In FY 2001, ED processed 97.2 percent of its 19,613 payments on time, representing \$1.137 billion. Late payment penalties were paid on 565 invoices.



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

**MANAGEMENT CHALLENGES OF THE DEPARTMENT OF EDUCATION
FEBRUARY 2002**

The Office of Inspector General's (OIG) strategic goals include improving the Department's programs and operations and protecting the integrity of those programs and operations. We are committed to ensuring the proper, efficient, and effective use of federal education funds, and welcome our continued partnership with the Secretary and the Congress in this endeavor. We have determined that the top management challenges now facing the Department of Education (the Department or ED) are:

- Correct long standing financial management problems
- Strengthen information technology security
- Improve internal controls
- Improve contract monitoring
- Balance compliance monitoring and technical assistance
- Meeting its goal of removing the student financial assistance programs from the General Accounting Office "high risk" list
- Pursue appropriate electronic government initiatives
- Improve strategic management of human capital
- Improve and test continuity of operations plans
- Improve management of IT assets
- Obtain reliable performance data and improve performance measures

We have identified these challenges from our work--our audits, inspections, and investigations--and from the priorities identified by the Administration and the Department. The latter include:

- ✓ the President's Management Agenda for Fiscal Year 2002,
- ✓ ED's Blueprint for Management Excellence and Action Plan (October 30, 2001) developed by the Department's Management Improvement Team (MIT)
- ✓ ED's Strategic Plan for 2002-07 (currently in draft for 2002-07)

With regard to each challenge, below we explain why we judge it to be a priority for the Department and how the Department is addressing it. We also attach a list identifying our work most pertinent to each challenge.

More detailed information about our work can be found on our website, www.ed.gov/offices/OIG. The website for the Department's Strategic Plan and MIT are <http://www.ed.gov/inits/mit/index.html> and <http://www.ed.gov/pubs/stratplan2001-05/index.html>.

Lorraine Lewis

Lorraine Lewis

• **CHALLENGE: Correct long standing financial management problems**

The Department is responsible for over \$100 billion dollars each year through both appropriations and loan programs. Sound financial management of these funds is critical for the financial integrity of the Department's programs and operations. The President has stressed the need for accurate and timely financial information and demanded that each agency obtain clean audits of its financial statements by the fiscal year (FY) 2002 audits. Although the Department has not achieved this goal for the last three years, it has recognized the challenge and is working to develop and maintain financial integrity.

Department's Efforts

For the last two years, the Department has met the statutory deadline for submission of its financial statement audit, and has developed a schedule to do so again this year. In October 2001, the Department reported that it completed corrective action on approximately 58 percent of the recommendations being tracked by the MIT and developed corrective action plans for another 30 percent. It also has purchased and is implementing a new financial management system--Oracle Federal Financials--hired new financial managers, brought in experts from the Treasury Department, and enlisted the assistance of private sector accounting firms. In addition, the Department identified a number of financial management issues in its Blueprint that need to be resolved.

Planned OIG Work

We are auditing the Department's implementation of its new financial management system and producing a series of reports. We also are responsible for the independent audits of the two sets of FY 2001 financial statements--the Department's and those of Student Financial Assistance (SFA). These results are presented in the Reports of Independent Auditors, the Reports on Internal Controls and the Reports on Compliance with Laws and Regulations.

Our results will provide the performance measure of the Department's progress in meeting the goals of the President's Management Agenda and the Department's Blueprint and Strategic Plan. We also are responsible for the audits of the Department's and SFA's FY 2002 financial statements.

• **CHALLENGE: Strengthen information technology security**

In light of the events of September 11th and the continued threat of terrorist attacks, the importance of information technology (IT) security is even more vivid. The Department's IT systems must be capable of ensuring the availability, confidentiality, and protection of the data they contain. Improved IT security can also enable the Department to safely expand its use of technology to better serve its customers.

In our Government Information Security Reform Act (GISRA) report of September 2001, we found significant IT deficiencies in the Department. These deficiencies included incomplete risk assessments and lack of tested disaster recovery plans. In addition, most systems have not undergone a formal certification and accreditation process. We recommended 15 corrective actions that the Department needs to take to safeguard the security of its systems that deliver critical services, such as loans and assistance to public schools. We had previously identified security and disaster recovery weaknesses related to the Department's systems.

Department's Efforts

The Department has recognized this challenge in both its Blueprint and Strategic Plan. It is working to improve coordination of IT security and has dedicated more resources to improving IT security.

OIG Planned Work

We are initiating our 2002 GISRA review which will focus on several areas including the Department's compliance with OMB Circular A-130. In addition, we will verify the effectiveness of the Department's corrective actions to reduce security risks we identified previously. We also plan another assessment of the Department's disaster recovery plans for certain IT systems.

• CHALLENGE: Improve internal controls

A strong set of internal controls is essential for reliable financial reporting and for protecting programs and operations from waste, fraud, and abuse. It is also an important element of the President's and the Department's efforts to strengthen financial management. We have found weaknesses in the Department's internal controls in several areas, including purchase cards, third party drafts, cellular telephones, the contract payment process, and the audit follow-up process.

Department's Efforts

The Department has concurred with many of the recommendations in our reviews and is implementing corrective action plans. It has recognized the need to strengthen its internal controls and to incorporate a stronger culture of accountability in the Department. It has initiated management improvement training programs including internal controls training.

OIG Planned Work

We are performing reviews to examine the Department's controls over travel cards and telephone calling cards. We identify and analyze management controls while conducting internal audit projects. We are also conducting a number of criminal investigations where criminal opportunities arose in an environment of weak or non-existent internal controls.

We will strengthen our efforts to analyze data for fraud indicators and other anomalies. We will continue to refer fraud allegations for possible prosecution, and where appropriate, refer non-criminal matters to responsible managers for administrative action.

• **CHALLENGE: Improve contract monitoring**

The Department must improve its contract monitoring to ensure that contract terms and conditions are met and that it receives the high-quality goods and services required. The Department now contracts for many services, with more individuals working under contracts than as federal employees. Implementation of the Federal Activities Inventories Reform Act (FAIR) and the President's emphasis on competitive sourcing likely will lead to additional contracting out.

We have performed a number of audits and found weaknesses in the Department's contract monitoring processes, including its controls over government property. These weaknesses can result in lost and misused property, misused government funds, or frauds--as reflected in our investigative work.

Department's Efforts

The Department has recognized the mandate for competitive sourcing but needs to improve its contractor oversight to protect the Government's interests adequately.

OIG Planned Work

We have audits underway on monitoring non-SFA contracts and SFA's contract for modernization of its IT systems. We also plan to perform contract closeout audits on four Regional Education Laboratory contracts.

• **CHALLENGE: Balance compliance monitoring and technical assistance**

The Department must strengthen its compliance monitoring and balance this monitoring with technical assistance. Stronger compliance monitoring would help ensure the integrity, efficiency, and effectiveness of these programs.

Over the past few years, the department has emphasized technical assistance, rather than compliance monitoring. This emphasis has weakened the Department's oversight. For example, our audits of the Department's monitoring process for both discretionary and formula grant programs found weaknesses including the lack of provisions to identify high-risk grantees. We also found that the Department did not fully implement its guidance for monitoring discretionary grants. Further, our work in Puerto Rico on Title I grant administration found major deficiencies in cash management and the procurement process. A joint OIG/FBI investigation

resulted in the indictment of 17 people for the illegal diversion of federal education funds. In addition, we found that the Department has significantly reduced on-site compliance monitoring over student financial assistance programs and has focused on technical assistance.

Department's Efforts

The Department is revising its directive for monitoring discretionary grants and plans training on the directive by the end of FY 2002. The Office of Elementary and Secondary Education is also revising its monitoring process for formula grants. The Department also agreed with our audit recommendations on balancing compliance monitoring and technical assistance in student financial assistance programs.

OIG Planned Work

We will follow-up on our previous work to assess the Department's progress in compliance monitoring of SFA programs.

- **CHALLENGE: Meeting its goal of removing the student financial assistance programs from the General Accounting Office "high risk" list**

Student financial assistance programs have been on the "high risk" list of the General Accounting Office (GAO) since 1995. Our reviews have identified numerous shortcomings in the Department's oversight of these programs, including insufficient oversight and inadequate program enforcement. In addition, these programs are the largest focus of our investigation efforts relating to fraud perpetrated by third parties on the Department.

One way to lower risk in student financial assistance programs is to have a system to match the income an applicant claims on the Free Application for Federal Student Aid (FAFSA) with the records of the Internal Revenue Service (IRS). We recommended this match in 1997, and the Higher Education Amendments of 1998 provided certain authorization. The President's proposed budget for fiscal year 2003 requests further authority for the IRS to implement this match.

Department's Efforts

The Department has established a goal of removing these programs from the GAO "high risk" list. Many of its Blueprint action items support that goal. The Department continues to work with the IRS, Office of Management and Budget (OMB), and Congress to address further legislative changes related to the match. The Department has performed two sample income matches with IRS.

OIG Planned Work

We continue to investigate cases of applicants providing false income information on the FAFSA and preparers who assist applicants in this fraudulent activity. We continue to recommend that Congress enact whatever legislative changes are necessary to implement the match.

• CHALLENGE: Pursue appropriate electronic government initiatives

The President has directed agencies to enhance electronic government (e-government) to provide greater services at lower cost and to meet high public demand for e-government services. The Government Paperwork and Elimination Act (GPEA) requires agencies to increase use of electronic forms and processes. These processes must be performed in a way that ensures data integrity and confidentiality.

The purpose of e-government is not simply to replace paper transactions with electronic ones. It is intended to streamline systems across agencies, eliminate redundant systems, reduce costs, and simplify interactions with the public.

Department's Efforts

The Department has acknowledged the need for e-government services and has updated its GPEA plan and submitted a progress report to OMB. It has also assumed leadership for Online Access for Loans, a program to streamline the loan application process across multiple agencies.

OIG Planned Work

We have initiated a review of the Department's progress in implementing GPEA and in automating its business process. Our review will focus on the Department's planning and transition to e-government applications. We also plan to review the Department's implementation of its responsibilities under the Online Access for Loans programs.

• CHALLENGE: Improve strategic management of human capital

The dynamics effecting the Federal workforce--the need for technology skills, the high percentage of employees nearing retirement, the drive toward competitive sourcing--make this a critical issue on the President's agenda, and those of GAO and the Department. The Department has recognized the need to align its human capital planning with its goals and mission to develop a workforce that is responsive and efficient.

Department's Efforts

The Department's Blueprint action plan establishes an aggressive agenda and timetable to address this challenge. The Office of Management has also established a team to work on the human capital issue and develop recommendations.

OIG Planned Work

We are beginning a series of inspections addressing human capital issues. We will provide independent analysis of the Department's plans and products as it moves through its human capital action items.

• CHALLENGE: Improve and test continuity of operations plans

The importance of plans to continue operations and delivery of services has taken on new urgency since September 11. The Department and OIG experienced numerous problems in the New York regional office. The Department has acknowledged the need for plans to address interruptions of resources such as working space, telephone and utility services, IT systems, and mail delivery. The Department's existing continuation of operations plan (COOP) was prepared in 1999 and addressed disruptions only at its Washington headquarters offices. In addition, its COOP lacks clear emergency procedures.

Our work and meetings with Department officials indicates that while efforts are underway to develop plans for continuity of operations, much remains to be done. Our audits also identified vulnerabilities in disaster recovery planning for important IT systems. We recommended the inclusion of the lack of adequate continuity of operations as a material weakness in the Department's Federal Managers' Financial Integrity Act (FMFIA) report.

Department's Efforts

The Department acted quickly when Department offices (including the OIG regional office) were affected in New York City. The Department has received additional COOP guidance from the White House and is working to meet this guidance. The Department's Blueprint establishes some action items related to disaster recovery and infrastructure protection.

OIG Planned Work

We plan to review the Department's preparedness to respond to disruptions and the Department's activities to improve its preparedness. We will also review the adequacy of service continuity provisions for select Department systems.

• **CHALLENGE: Improve management of IT assets**

The Department must meet the requirements of the Clinger-Cohen Act which requires agencies to institute specific practices to improve management of IT including acquisition, use, and disposal of IT resources. Our prior work led to an agreement between OIG and the Office of the Chief Information Officer (OCIO) on a corrective action plan to address our recommendations in key areas of the Act.

Department's Efforts

The Department has taken several actions to improve IT capital planning and investment control, IT architecture, and IT skills of agency personnel--three key requirements of the Act. The Department's Blueprint also identified actions needed to improve management of IT resources.

OIG Planned Work

We have started an audit to review the Department's continued progress in meeting the Act's requirements. We will focus on the student financial assistance programs which comprise over 80 percent of the Department's IT budget. We also plan to perform an assessment of the Department's overall IT architecture and the effectiveness of its efforts to improve the IT skills of its personnel.

• **CHALLENGE: Obtain reliable performance data and improve performance measures**

In order to meet the President's directive to better integrate budget and performance data, the Department must improve its performance measures and obtain reliable performance data. To meet the requirements of the Government Performance and Results Act (GPRA) the data used for performance measures must be reliable, valid, and timely and should focus on program performance.

The Department must ensure that the performance measures it selects focus on outcomes, so that measures have value in improving programs and operations. It must also ensure the reliability, validity, and timeliness of data used for these measures. The Department also needs to examine its reliance on data from third parties. In our work, we have found weaknesses in the reliability, validity, and timeliness of data reported to the Department in certain programs.

Department's Efforts

The Department plans to publish a document that integrates performance and financial reports to demonstrate the relationship of financial and program management. It also has recognized the importance of tracking performance to goals in its planned efforts to strengthen the culture of accountability in the Department and in its objective to link federal education funding to accountability for results.

OIG Planned Work

We are participating in a joint audit with GAO and others to determine the reliability, validity and timeliness of Title I performance data used to identify schools that need improvement. We are also performing an audit on the adequacy of internal controls for scoring of the National Assessment of Education Progress. In addition, we will determine whether there are established GPRA goals and measures for each project in our FY 2002/2003 Work Plan. We will review these goals and measures if they are present, and if not, determine whether to recommend their inclusion.

**OFFICE OF INSPECTOR GENERAL
AUDITS AND INSPECTIONS
RELATED TO
U.S. DEPARTMENT OF EDUCATION
MANAGEMENT CHALLENGES
FEBRUARY 2002**

These reports represent some of our most pertinent recent work related to the top management challenges now facing the Department of Education.

- **CHALLENGE: Correct long standing financial management problems**
 - FY 2000 Annual Financial Statements (A17-A0002, 2/29/2001)
 - Management Letter FY 2000 (A17-B0003, April 2001)
 - Student Financial Assistance FY 2001 Financial Statements (A17-A0003)
 - Management Letter, Student Financial Assistance FY 2000 (April 2001)
 - Analysis of GAPS Duplicate Payments (3/30/2001)
 - Monitoring of ED's Implementation of Oracle Federal Financials (Phase 1), (Letter Report, 12/17/2001)

- **CHALLENGE: Strengthen information technology security**
 - Department of Education Implementation of GISRA (A11-B0007, 9/07/2001)
 - Review of Education's Disaster and Recovery Plans (A11-A0009, 11/28/2001)

- **CHALLENGE: Improve internal controls**
 - Review of Impact Aid Disbursement Process within the U.S. Department of Education, Office of Elementary and Secondary Education (S17-B0013, July 2001)
 - Review of the Formula Grant Disbursement Process within the U.S. Department of Education, Office of Vocational and Adult Education (S17-B0015, July 2001)
 - Review of the Discretionary Grant Disbursement with the U.S. Department of Education, Office of Educational Research and Improvement (S17-B0014, 7/19/2001)
 - Audit of Controls over Audit Followup Process (A19-B0002, October 2001)
 - Audit of Controls over Contract Payments (A07-A0015, March 2001)

- **CHALLENGE: Improve contract monitoring**
 - Audit of Controls over Government Property Furnished to Computer Sciences Corporation (A19-B0003, March 2001)
 - Audit of Controls over Government Property Furnished to Affiliated Computer Service, Inc. (A19-B0004, April 2001)
 - Audit of Controls over Government Property Managed by Raytheon Systems Company (A19-B0005, September 2001)

- **CHALLENGE: Balance compliance monitoring and technical assistance**
 - OIG Perspective on the Reauthorization of the Elementary and Secondary Education Act (S14-80010, 11/99)
 - Review of the Office of Elementary and Secondary Education Discretionary Grants Monitoring Process (A03-A0021, 9/24/2001)
 - Audit of the U.S. Department of Education's Discretionary Grant Monitoring Process (A03-B0018, 10/24/2001)
 - Review of the Division of Vocational-Technical Education's Monitoring of Formula Grants (A04-A0013, 9/25/2001)
 - Review of the Office of Elementary and Secondary Education's Monitoring of Formula Grants (A04-A0013, 11/26/2001)
 - Monitoring of Formula Grants (A04-B0008, 11/27/2001)

- **CHALLENGE: Meeting its goal of removing student financial assistance programs from the General Accounting office "high risk" list**
 - Audit of Commissioned Sales and Course Length at Benedictine University (A05B0003, 12/13/2001)
 - Audit of Student Financial Assistance Enforcement of the Institutional Financial Responsibility Regulations. (A09A0018, 09/28/2001)
 - Audit of Course Length at William Penn University (A05B0014, 9/28/2001)
 - Audit of Olivet Nazarene University, School of Graduate and Adult Studies Administration of Title IV Programs, (A05B0004, 09/28/2001)
 - Audit of Indiana Wesleyan University, Adult and Professional Studies Administration of Title IV Programs, (A05B0007, 09/25/2001)
 - Audit of The Michigan Guaranty Agency's Administration of the Federal Family Education Loan Program Federal and Operating Funds (A19B0005, 19/2001)
 - Audit of Controls over Government property managed by Raytheon Systems Company (A19-B0005, 9/19/2001)
 - Audit of the Implementation of the District of Columbia College Access Act of 1999 (A06A0015, 08/29/2001)
 - Audit of ESS College of Business' Administration of the Title IV Student Financial Assistance Programs (A05A0030, 05/21/2001)
 - Audit of the Title IV Programs Administered by Olivet Nazarene University's School of Graduate and Adult Studies, Bourbonnais, Illinois (A09A0021 9/18/2001)
 - Audit of Indiana State University's Policies and Procedures Covering Educational Programs and Courses Delivered Through Distance Education Methods (A09-A0021, 5/18/2001)
 - Audit of Commissioned Sales at William Penn University (A0790035_5/15/2001)

- **CHALLENGE: Pursue appropriate electronic government initiatives**
 - Review of Department's Fall 2000 GPEA plan

- **CHALLENGE: Improve and test continuity of operations plans**
 - Review of the Department's Disaster and Recovery Plans (A11-A0009, 11/28/2001)

- **CHALLENGE: Improve management of IT assets**
 - OIG monitors Department's actions to correct deficiencies identified in Clinger-Cohen audit (A11-7007, 3/31/98)
- **CHALLENGE: Obtain reliable reporting data and improve performance measures**
 - State-Reported Data Used to Evaluate Performance of the Individuals with Disabilities Education Act (Information Memorandum, 9/28/2001)
 - Audit of Michigan Department of Education Management Controls over IDEA, Part B Special Education Performance Data (A05-A0031, 9/21/2001)
 - Audit of Kansas State Department of Education Management Controls over IDEA Part B Special Education Performance Data (A07-A0020, 7/20/2001)
 - California Department of Education Management Controls over IDEA, Part B Special Education Performance Data (A09-A0016, 3/30/2001)
 - Arizona Department of Education Management Controls over IDEA, Part B Special Education Performance Data (A09-A0001, 9/22/2000)
 - Department Controls over TRIO Grantee Monitoring (A07-90034, 1/4/2002)

Limitations of the Financial Statements

The following limitations apply to the preparation of the FY 2001 Financial Statements:

- The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515 (b).
- While the statements have been prepared from the books and records of the entity in accordance with generally accepted accounting principles (GAAP) for Federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.
- The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

PART II
**Principal Financial Statements, Notes and
Required Supplementary Information**

Supplementary Information

Attachments

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Consolidated Balance Sheet
As of September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Assets		
Intragovernmental Assets:		
Fund Balance with Treasury (Note 2)	\$40,476,338	\$42,160,719
Accounts Receivable, Net (Note 3)	10,730	
Interest Receivable	57	70,755
Governmental Assets:		
Accounts Receivable, Net (Note 3)	113,083	82,703
Credit Program Receivables, Net (Note 4)	80,698,787	70,472,689
Advances	38,738	38,739
Cash and Other Monetary Assets		14,132
Property and Equipment (Note 5)	25,224	1,307
Other Governmental Assets	259,945	236,363
Guaranty Agency Federal & Restricted Funds Receivable (Note 3)	2,462,445	2,231,814
Total Assets	\$124,085,347	\$115,309,221
Liabilities		
Intragovernmental Liabilities:		
Accounts Payable	\$22,293	\$6,647
Interest Payable	7,866	83,469
Borrowing from Treasury (Note 6)	77,448,205	65,715,386
Guaranty Agency Federal & Restricted Funds Due To Treasury (Note 3)	2,462,445	2,231,814
Payable to Treasury (Note 7)	4,212,555	7,860,621
Payable to Federal Financing Bank (Note 8)	31,349	20,699
Other Intragovernmental Liabilities (Note 9)	44,857	362,823
Governmental Liabilities:		
Accounts Payable	590,921	213,051
Accrued Grant Liability (Note 10)	1,854,940	2,006,129
Liabilities for Loan Guarantees (Note 4)	8,376,767	9,978,668
Other Governmental Liabilities (Note 9)	381,264	231,158
Total Liabilities	\$95,433,462	\$88,710,465
Net Position		
Unexpended Appropriations (Note 11)	\$30,691,817	\$26,722,760
Cumulative Results of Operations (Note 11)	(2,039,932)	(124,004)
Total Net Position	\$28,651,885	\$26,598,756
Total Liabilities and Net Position	\$124,085,347	\$115,309,221

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Consolidated Statement of Net Cost
For the Years Ended September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Program Costs		
Intragovernmental		
Interest Expense, Federal (Note 12)	\$5,578,045	\$4,993,313
Other Production Expense		434
Grant Expense	71,180	79,460
Contractual Service Expense	81,349	57,754
Salaries and Administrative Expense (Note 13)	153,433	147,010
Bad Debt & Write-offs	38	2,050
Other Program Expenses		800
Governmental		
Subsidy Expense (Note 4)	999,287	(3,637,993)
Grant Expense	37,068,699	34,715,035
Interest Expense, Non-Federal (Note 12)	411	305
Contractual Service Expense	805,532	827,976
Salaries and Administrative Expense (Note 13)	436,586	438,907
Bad Debt & Write-offs	588	14
Other Program Expenses	199,590	180,207
Total Program Cost	\$45,394,738	\$37,805,272
Less: Earned Revenues		
Interest, Federal (Note 12)	\$1,522,371	\$1,761,285
Interest, Non-Federal (Note 12)	4,058,251	3,234,323
Other Earned Revenue	6,153	90,840
Earned Revenues	\$5,586,775	\$5,086,448
Net Cost of Operations	\$39,807,963	\$32,718,824

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Consolidated Statement of Changes in Net Position
For the Years Ended
September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Net Cost of Operations	\$(39,807,963)	\$(32,718,824)
Financing Sources (Other than Exchange Revenues):		
Appropriations Used	\$40,730,970	\$37,238,317
Donations (Non-exchange Revenue)	535	1,016
Imputed Financing (Note 14)	20,600	20,795
Future Transfers Out due to Downward Subsidy Re-estimate	(2,707,275)	(4,010,604)
Total Financing Sources	\$38,044,830	\$33,249,524
Net Results of Operations	\$(1,763,133)	\$530,700
Prior Period Adjustments (Note 15)	(152,829)	(873,584)
Net Change in Cumulative Results of Operations	\$(1,915,962)	\$(342,884)
Increase (Decrease) in Unexpended Appropriations	3,969,091	(4,039,342)
Change in Net Position	\$2,053,129	\$(4,382,226)
Net Position - Beginning of Period	26,598,756	30,980,982
Net Position - End of Period	\$28,651,885	\$26,598,756

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Combined Statement of Budgetary Resources
For the Years Ended September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Budgetary Resources		
Budget Authority	\$69,343,857	\$56,900,834
Unobligated Balance-Beginning of Period (Adjusted) (Note 16)	10,529,655	13,864,271
Spending Authority from Offsetting Collections (Adjusted)	27,638,727	21,346,713
Adjustments	(13,393,186)	(10,844,127)
Total Budgetary Resources (Note 17)	\$94,119,053	\$81,267,691
Status of Budgetary Resources		
Obligations Incurred (Adjusted) (Note 16)	\$86,385,110	\$70,697,100
Unobligated Balances-Available	2,213,757	1,822,381
Unobligated Balances-Not Available	5,520,186	8,748,210
Total Status of Budgetary Resources (Note 17)	\$94,119,053	\$81,267,691
Outlays		
Obligations Incurred (Adjusted) (Note 16)	\$86,385,110	\$70,697,100
Less: Spending Authority from Offsetting Collections (Adjusted)	(34,131,697)	(21,916,198)
Obligated Balance, Net-Beginning of Period (Adjusted) (Note 16)	36,112,102	36,166,395
Less: Obligated Balance, Net-End of Period (Adjusted)	(36,087,219)	(36,339,231)
Total Outlays (Note 17)	\$52,278,296	\$48,608,066

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Combined Statement of Financing
For the Years Ended September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Obligations and Nonbudgetary Resources (Note 18)		
Obligations Incurred (Adjusted) (Note 16)	\$86,385,110	\$70,697,100
Spending Authority from Offsetting Collections and Adjustments (Adjusted)	(34,131,697)	(21,916,198)
Financing Imputed for Cost Subsidies (Note 14)	20,600	20,795
Financing Sources Transferred Out	(2,707,275)	(4,010,604)
Exchange Revenue Not In the Entity's Budget	4,837,150	4,366,080
Other	(17,221)	(23,089)
Total Obligations and Nonbudgetary Resources	\$54,386,667	\$49,134,084
Resources That Do Not Fund Net Cost of Operations (Note 18)		
Change in Amount of Goods, Services, and Benefits Ordered But Not Yet Provided (Net Increases) Net Decreases	(\$1,009,541)	\$2,423,469
Credit Program Collections that Increase Liabilities for Loan Guarantees or Allowance for Subsidy	11,471,786	8,996,426
Resources that Fund Expenses Recognized in Prior Periods	(41,431)	(33,759)
Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	(35,192,107)	(31,352,816)
Other Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	4,197,500	4,287,021
Total Resources That Do Not Fund Net Cost of Operations	\$(20,573,793)	\$(15,679,659)
Costs That Do Not Require Resources (Note 18)		
Adjustments	\$75,145	\$(360,763)
Total Costs That Do Not Require Resources	\$75,145	\$(360,763)
Financing Sources Yet to be Provided (Note 18)	\$5,919,944	\$(374,838)
Net Cost of Operations (Note 19)	\$39,807,963	\$32,718,824

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

Note 1. Summary of Significant Accounting Policies

Reporting Entity

The **U.S. Department of Education** (the Department) was established on May 4, 1980, by Congress, under the Department of Education Organization Act of 1979 (Public Law 96-88). It is responsible, through the execution of its congressionally approved budget, for administering direct loan, guaranteed loan, and grant programs.

The Department's **Office of Student Financial Assistance** (SFA) administers the Federal Direct Student Loan Program, the Federal Family Education Loan (FFEL) Program, Pell Grants, and the Campus-Based Program. The **Federal Direct Student Loan Program**, authorized by the Student Loan Reform Act of 1993, makes loans directly to eligible undergraduate and graduate students and their parents through participating schools. Funds are borrowed from the Treasury Department to fund these loans. The **Federal Family Education Loan (FFEL) Program**, authorized by the Higher Education Act (HEA) of 1965, as amended, cooperates with state and private nonprofit Guaranty Agencies to provide loan guarantees and interest subsidies on loans made by private lenders to eligible students. The **Pell Grant** and **Campus-Based Programs** provide educational grants and other financial assistance to eligible applicants.

The Department also administers numerous grant programs and the Facilities Loan Program. **Grant** programs include grants for the disadvantaged, elementary and secondary education, special education and rehabilitative services, and educational research and improvement. Through the **Facilities Loan Program**, the Department administers low interest loans to institutions of higher learning for the construction and renovation of facilities.

Basis of Accounting and Reporting

The financial statements present the financial position of the Department as of September 30, 2001 and 2000, including the statements of net cost, changes in net position, budgetary resources, and financing. This disclosure is required by the Chief Financial Officers Act of 1990 (Public Law 101-576), and the Government Management Reform Act of 1994 (GMRA). The financial statements were prepared from the books and records of the Department, in accordance with accounting principles generally accepted in the United States. The accounting principles are promulgated by the Federal Accounting Standards Advisory Board (FASAB) and are presented in the format prescribed by the Office of Management and Budget (OMB) Bulletin No. 97-01, as amended and OMB Bulletin No. 01-09. These statements are different from the financial reports, also prepared by the Department pursuant to other OMB directives that are primarily used to monitor and control the use of budgetary resources. The balance sheet, statement of net cost, and the statement of changes in net position consolidate the balances of 215 discrete appropriations that comprise 31 fund accounts within eight reporting groups.

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

The reporting groups include: Student Financial Assistance (SFA); Office of Elementary and Secondary Education (OESE); Office of Special Education and Rehabilitative Services (OSERS); Office of Vocational and Adult Education (OVAE); Office of Postsecondary Education (OPE); Office of Educational Research and Improvement (OERI); Office of Bilingual Education and Minority Languages Affairs (OBEMLA); and Department Management (DM).

The accounting structure reflects both accrual and budgetary accounting transactions. Under accrual accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash. Under budgetary accounting, budgetary resources are obligated based on legal requirements, which may differ from when an accrual-based transaction is recorded.

Use of Estimates

The preparation of financial statements in accordance with generally accepted accounting principles in the United States requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements, actual results may differ from those estimates.

Estimates for the credit program receivables and liabilities contain assumptions that significantly impact the financial statements. The primary components of this assumption set include, but are not limited to, collections, repayments, default rates, prevailing interest rates, and loan volume. Actual loan volume, interest rates, cash flows and other critical components used in the estimation process may differ significantly from the assumptions made at the time the financial statements were prepared. Minor adjustments to any of these assumption components can create significant changes in the estimate.

The Department recognizes the sensitivity of the changes in assumptions and the impact that the projections can have on the estimate. As a result, management has attempted to mitigate these fluctuations by utilizing historical trend analysis to project future cash flows. The assumptions used for the September 30, 2001 and 2000 financial statements are based on the best information available at the time the estimate was derived.

The Department and OMB have established a Student Loan Credit Modeling Working Group that will refine the underlying assumptions used to generate baseline and policy estimates. The Working Group plans to summarize the key issues regarding the subsidy calculation methodology, which requires an OMB policy decision. This is expected to occur in time for the Mid-Session review of the FY2003 Budget.

At this time, the Working Group has not determined a specific set of alternative assumptions or model structures. The use of an alternative set of assumptions or model

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

configurations is considered a change in estimate and may produce cost estimates significantly different than those reflected in these financial statements.

Present Value Credit Program Receivables and Loan Guarantee Liabilities

The financial statements at September 30, 2001 and 2000 reflect the Department's estimate of the long-term cost of direct and guaranteed loans in accordance with the Federal Credit Reform Act of 1990 (the Act).

The Act requires that the net present value of the estimated long-term cost to the government of new direct loans and loan guarantees be financed from new budget authority and recorded as budget outlays at the time the direct loan or guaranteed loans are disbursed. The FASAB's Statement of Federal Financial Accounting Standard (SFFAS) No. 2, Accounting for Direct Loans and Loan Guarantees, and related regulations and guidance, defines subsidy costs as the present value of interest subsidies, defaults, fee offsets, and other cash flows associated with direct loans and loan guarantees in the year loans are disbursed. The Department records subsidy costs as an allowance to direct loans receivable or as a liability for loan guarantees.

Subsidy costs are estimated based on the difference between the present value of expected government cash outflows (e.g. interest the government pays to borrow, interest subsidies, and defaults) and inflows (e.g. interest income from borrowers and collections of fees), discounted by the average interest rate on marketable Treasury securities. Direct Loan subsidy costs are recognized as an expense in the year the loans are disbursed. Guaranty Loan subsidy costs are re-estimated each year. The Department is consistent with SFFAS Standard No. 2 in its treatment of pre-FY92 loan receivables and loan guarantees. SFFAS Standard No. 2 allows pre-FY92 loan receivables and loan guarantees to be valued at net realizable value or expected value, respectively, or at the net present value of their cash flows. The Department values pre-1992 loan receivables and loan guarantees at the net present value of their cash flows.

The Department has included additional disclosure in Note 4 as required by FASAB's SFFAS No. 18 for FY2001, which is included in Note 4. Subsidy re-estimates, the interest rate re-estimate and the technical/default re-estimate are separately disclosed. A reconciliation is provided between the beginning and ending balances for the subsidy cost allowance for direct loans and the liability for loan guarantees.

Budget Authority

Budget authority is the authorization provided by law for the Department to incur financial obligations that will result in outlays. The Department's budgetary resources as of September 30, 2001 include current authority (appropriations and borrowing authority) and unobligated balances remaining from annual, multi-year, and no-year budget authority received in prior years. Budgetary resources also include reimbursements received and other revenue (spending authority from offsetting collections credited to an

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

appropriation account and recoveries of prior year obligations). Pursuant to Public Law 101-510, unobligated balances associated with appropriations expiring at the end of the fiscal year remain available for obligation adjustment for five years, after which the account is cancelled.

Borrowing from Treasury provides most of the funding for the loan principal disbursements made under the Federal Direct Student Loan Program. The costs of the Department's programs are generally funded with congressional appropriations. Revenues are recognized from other agencies and from the public in exchange for goods or services. Major sources of reported revenue include interest income recognized from the Federal Direct Student Loan Program borrowers on outstanding loans receivable and interest accrued from Treasury on undisbursed loan balances.

Property and Equipment

The Department capitalizes single items of property and equipment with an aggregate cost of \$50,000 or more that have an estimated useful life greater than 2 years. The Department also capitalizes bulk purchases of property and equipment with an aggregate cost of \$500,000 or more. A bulk purchase is defined as the purchase of like items related to a specific project or the purchase of like items that occur within the same fiscal year that have an estimated useful life greater than 2 years. In accordance with SFFAS No. 6, Accounting for Property, Plant and Equipment, these assets are depreciated using the straight-line method. The Department adopted the following useful lives for classes of depreciable property:

- 3-Year Property – Information Technology (IT) and Telecommunications equipment
- 5-Year Property – Furniture and Fixtures.

Leases

The Department leases office space from the General Services Administration (GSA). Future lease payments are not accrued as liabilities as these lease agreements generally meet the requirements of operating leases. Leased office space costs for FY2001 amounted to approximately \$50.8 million, of which \$17.0 million related to non-GSA owned office space. In FY2000, leased office costs amounted to approximately \$48.8 million, of which \$15.6 million related to non-GSA owned office space. Under existing commitments as of September 30, 2001, estimated future minimum lease payments are as follows:

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

**Future Minimum Lease Payments
at September 30
(Dollars in Thousands)**

<u>Fiscal Year End</u>	<u>Amount</u>
2002	\$22,475
2003	21,898
2004	22,353
2005	23,007
After 2005	23,484
Total	\$113,217

The Department does not have any capital leases.

Accounts Receivable

Accounts receivable are amounts due the Department from the public and other federal agencies. Receivables from the public typically result from items such as overpayments of educational assistance, while amounts due from other federal agencies result from agreements entered into by the Department with these agencies. Accounts receivable are recorded at cost less an allowance for uncollectible amounts.

Accounts Receivable – Guaranty Agency Reserves

Section 422A of the Higher Education Act of 1965 (HEA), as amended, required FFEL Guaranty Agencies to establish a Federal Student Loan Reserve Fund (the “Federal Fund”) and an Operating Fund by December 6, 1998. The Federal Fund and the non-liquid assets developed or purchased by a Guaranty Agency as a result, in whole or in part with federal funds, are the property of the United States. However, such ownership by the Department is independent of the actual control of the assets.

The Department disburses funds to the Guaranty Agency through the Federal Fund for the payment of lender claims and default aversion fees of a Guaranty Agency. The Operating Fund is the property of the Guaranty Agency except for funds an agency borrows from the Federal Fund (under Section 422A of the HEA of 1965, as amended). The Operating Fund is used by the Guaranty Agency to fulfill its responsibilities. These responsibilities include repaying money borrowed from the Federal Fund, default aversion and collection activities.

Guaranty Agency Reserves consist of the Department’s interest in the net assets of FFEL Program Guaranty Agencies. Guaranty Agency assets include initial Federal start-up funds (Guaranty Agency advances), receipts of Federal reinsurance payments, insurance premiums, Guaranty Agency share of collections on defaulted loans, investment income and administrative cost allowances, and other assets purchased out of reserve funds.

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

Liabilities result from initial Federal start-up funds, lender claims, operating expenses and Federal reinsurance fees. Guaranty agency reserves are recorded as a governmental asset (see Note 3) and as a corresponding liability due to Treasury.

Liabilities

Liabilities represent actual and estimated amounts likely to be paid as a result of transactions or events that have already occurred. Liabilities without budget authority are classified as liabilities not covered by budgetary resources. FFEL and Federal Direct Student Loan Program liabilities result from entitlements covered by permanent indefinite budget authority.

Liabilities for Loan Guarantees

The liability for loan guarantees under the FFEL Program is the estimated long-term cost to the Department of its loan guarantees calculated on a net present value basis, excluding administrative costs. Obligations for subsidy cost are recorded against budget authority when a loan guarantee commitment is made. Subsidy costs are recognized as expenses in the year loans are disbursed. The subsidy cost is re-estimated each year. The re-estimation results in an increase or decrease of recognized subsidy expense.

Borrowing from Treasury

Programs are generally funded by congressional appropriations. However, borrowing from the U.S. Treasury provides most of the funding for loans made under the Federal Direct Student Loan Program and the Facilities Loan Program. The Department repays the loan principal based on available fund balances. Interest on the debt is calculated at fiscal year end using rates set by the U.S. Treasury. Principal and interest payments are remitted to the U.S. Treasury on an annual basis.

Accrued Grant Liability

Disbursements of grant funds are made to recipients through a drawdown request using the Grants and Administrative Payment System (GAPS). Drawdown requests typically are recorded as expenditures at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a drawdown request. Accordingly, a liability is accrued by the Department for expenditures incurred by grantees prior to the processing of a drawdown request. The accrual amount is estimated using statistical sampling techniques.

Net Position

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances, and exclude activity of the liquidating and financing accounts that are required under the

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

Federal Credit Reform Act of 1990. Cumulative results of operations represent the net result of operations since inception.

Prior Period Adjustments

Prior period adjustments are included in the calculation of the net change in cumulative results of operations. Prior period adjustments reflect correction of errors from prior periods.

Annual, Sick and Other Leave

The liability for annual leave, compensatory time off, and other leave is accrued when earned and reduced when taken. Each year, the accrued annual leave account balance is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Retirement Plans and Other Employee Benefits

Employees participate either in the Civil Service Retirement System (CSRS), a defined benefit plan, or the Federal Employees Retirement System (FERS), a defined benefit and contribution plan. For CSRS employees, the Department contributes 8.51 percent of pay. For FERS employees, the Department contributes 10.7 percent of pay to the defined benefit plan and 1 percent of pay to the thrift savings plan, a defined contribution plan. Additionally, the Department matches employee contributions to the thrift savings plan up to an additional 4 percent of pay. For FERS employees, the Department also contributes the employer's share for Social Security (FICA) and Medicare.

SFFAS No. 5, Accounting for Liabilities of the Federal Government, requires government agencies to report the full cost of employee benefits for CSRS, FERS, FEHB (Federal Employee Health Benefits), and FEGLI (Federal Employees Group Life Insurance). For financial statements, the Department uses the applicable cost factors provided by the Office of Personnel Management (OPM).

Federal Employees Compensation Act

A portion of the estimated liability for disability benefits assigned to the Department under the Federal Employees Compensation Act (FECA) is accrued. This estimated liability is administered and determined by the Department of Labor and is based on the net present value of estimated future payments.

Related Party Transactions

The Department's financial activities are interrelated with the Federal government as a whole. Specifically, the Department is subject to financial regulation and management

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

control by the Office of Management and Budget (OMB) and the U.S. Treasury. As a result of this relationship, operations may not be conducted and financial positions reported, as they would if the Department were a separate and unrelated entity.

Reclassifications

Reclassification adjustments were made to the September 30, 2000 balance sheet, statement of budgetary resources and statement of financing to enhance the usefulness of presenting comparative statements, as follows:

Amounts were reclassified from “liabilities for loan guarantees” to “credit program receivables, net”. The purpose of this reclassification is to align the present value of future cash flows for the FFEL program between defaults that have already occurred and future defaults.

Beginning obligations and obligations incurred were reduced for the FFEL program to conform the re-estimate process to those used in 2001. The reduction of the obligated balance and the corresponding increase in the unobligated balance reflects that a budgetary accounting event only occurs when an actual re-estimate is executed.

Note 2. Fund Balance with the U.S. Treasury

Fund Balance with Treasury at September 30 (Dollars in Thousands)		
	FY2001	FY2000
Appropriated Funds	\$33,130,371	\$29,993,164
Revolving Funds	7,143,257	12,104,012
<u>All Other Funds</u>	<u>202,710</u>	<u>63,543</u>
Total	\$40,476,338	\$42,160,719

The Fund Balance with the U.S. Treasury represents appropriated funds and revolving funds, which include undisbursed U.S. Treasury borrowings that are available to pay current liabilities and finance loan programs. The Department has the authority to disburse the funds directly to agencies and institutions participating in its programs. The U.S. Treasury processes cash receipts and disbursements on behalf of the Department. The undisbursed account balances are entity assets.

A portion of the appropriated funds included at September 30, 2001 was funded in advance by multi-year appropriations for expenditures anticipated during the current and future fiscal years. Revolving funds conduct continuing cycles of business-like activity and do not require an annual appropriation. The decrease in the revolving fund balance

United States Department of Education
Notes to Principal Financial Statements
September 30, 2001

for FY2001 is primarily due to the return of approximately \$4.7 billion to the U.S. Treasury relative to FFEL program cost re-estimates.

Note 3. Accounts Receivable

Accounts Receivable, Net Amount Due at September 30 (Dollars in Thousands)		
	<u>FY2001</u>	<u>FY2000</u>
Accounts Receivable		
Intragovernmental	\$ 10,730	\$ --
Governmental	113,083	82,703
Guaranty Agency Federal and Restricted Funds Receivable	2,462,445	2,231,814
Total Accounts Receivable	\$ 2,586,258	\$ 2,314,517

Accounts receivable represent balances due from recipients of grant and other financial assistance programs, and from other Federal agencies. They are recorded at their net realizable value. Estimates for the allowance for loss on uncollectible accounts are based on historical data.

Guaranty agency federal and restricted funds receivable are non-entity assets. Guaranty agency federal and restricted funds receivable are also a liability due to the U.S. Treasury and are considered intragovernmental liabilities. These balances represent the Federal government's interest in the net assets of state and non-profit FFEL Program Guaranty Agencies.

Note 4 Credit Program Receivables and Liabilities for Loan Guarantees

The Department operates the William D. Ford Direct Student Loan and Federal Family Education Loan (FFEL) programs to help students finance the costs of higher education. Under the programs, the Department makes loans directly or guarantees all or a portion of loans made by participating lending institutions to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education. Eligible higher education institutions include public and private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents receive loans regardless of income; student borrowers who demonstrate financial need also receive Federal interest subsidies.

Under the Direct Loan program, the Federal Government makes loans directly to students and parents through participating schools. Loans are originated and serviced through contracts with private vendors. Under the FFEL program, over 4,000 financial institutions make loans directly to students and parents. FFEL loans are guaranteed by the Federal Government against default, with 36 State or private non-profit guaranty

United States Department of Education
Notes to Principal Financial Statements
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agencies acting as intermediaries in administering the guarantees. Beginning with loans first disbursed on or after October 1, 1993, financial institutions became responsible for 2 percent of the cost of each default; guaranty agencies also began paying a portion of the cost (in most cases 5 percent) of each defaulted loan from Federal funds they hold in trust. FFEL participants receive statutorily set Federal interest and special allowance subsidies; guaranty agencies receive fee payments as set by statute. In most cases, loan terms and conditions under the two programs are identical.

The Federal Credit Reform Act of 1990 (the Act) governs the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees is referred to as “subsidy cost.” Under the Act, subsidy costs for loans obligated beginning in FY1992 are recognized at the net present value of projected lifetime costs in the year the loan is disbursed. Subsidy costs are revalued annually. Components of subsidy include interest subsidies, defaults, fee offsets, and other cash flows. Consistent with the Act, subsidy cash flows exclude direct Federal administrative expenses; however, contractual payments to third-party private loan collectors, who receive a set percentage of amounts they collect, are included in these cash flows.

The Department estimates all future cash flows associated with Direct Loans and FFEL. Projected cash flows are used to develop subsidy estimates, which, as noted above, represent the net present value of future Federal costs associated with direct loans and defaulted guaranteed loans. Subsidy costs can be positive or negative; negative subsidies occur when expected program inflows (e.g., repayments, fees) exceed expected Federal costs. Subsidy estimates are recorded as a change to direct and defaulted FFEL program loans receivable and the liability for guaranteed loans. The Department uses a computer-based cash flow projection model to calculate subsidy estimates for direct loans and defaulted guaranteed FFEL program loans, and for the FFEL program loan guarantee liability. Cash flows are projected over the life of the loan, aggregated by loan type, cohort year, and risk category. The loan’s cohort year represents the year a direct loan was obligated or a loan was guaranteed, regardless of the timing of disbursements. Risk categories include two-year colleges, freshmen and sophomores at four-year colleges, juniors and seniors at four-year colleges, graduate schools, and proprietary schools.

In recent years, the consolidation of existing loans into new direct or guaranteed loans has increased significantly. Under the Act and requirements provided by OMB Circulars A-11 (Budget Formulation) and A-34 (Budget Execution), the retirement of loans being consolidated is considered a receipt of principal and interest, even though no cash is received from the borrower because a new consolidated loan is created. Under this definition of collections, defaults on loans in any given cohort are reduced in that refinancing provides payment of defaulted loans in the cohort and opens new loans in a current cohort. This consolidation activity and resulting refinancing is taken into consideration in setting the subsidy rate for defaults.

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The FFEL estimated liability for loan guarantees is reported at the present value of estimated net cash outflows. Defaulted FFEL loans are reported net of an allowance for subsidy computed using net present value methodology, including defaults, collections, and other cancellations. The same methodology is used to estimate the allowance on Direct Loan receivables.

The Department disbursed \$18 billion in Direct Loans to eligible borrowers in FY2001 and \$16 billion in loans in FY2000. Half of all volume is obligated in the fourth quarter of the fiscal year. Loans typically disburse in multiple installments over an academic period; as a result, multiple loan disbursements for a cohort year often cross fiscal years. Regardless of the fiscal year in which they occur, disbursements are tracked back to the cohort of obligation.

As of September 30, 2001 and 2000, the total principal balance outstanding of guaranteed loans held by lenders was approximately \$160 billion and \$146 billion, respectively. As of September 30, 2001 and 2000, the maximum government exposure on outstanding guaranteed loans held by lenders was approximately \$157 billion and \$143 billion, respectively. Of the insured amount, the Department would pay a smaller amount to the guaranty agencies, based on the appropriate reinsurance rates, which range from 100 to 95 percent. Any remaining insurance not paid as reinsurance would be paid to lenders by the guaranty agencies from their Federal funds. Payments by guaranty agencies do not reduce government exposure, however, since these payments are made from Federal funds. The liability and allowance estimates on the Department's books are independent of these guaranty agency Federal funds, since they are considered outside the direct or indirect control of the Secretary.

The Department accrues interest on its outstanding performing direct loans. In accordance with SFFAS No. 1, *Selected Assets and Liabilities*, the Department accrues, but does not report, interest on non-performing loans. Given the Department's comprehensive compromise authority, there is limited expectation of collection of accrued interest and fees on defaulted loans. Collections from borrowers are allocated to principal, interest, and fees, as appropriate. Non-performing loans have been in default an average of four years before they are assigned to the Department. Program data indicate that significant collections are made later in the life of non-performing student loans.

As previously noted, borrowers may pre-pay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan. The loan liability and net receivable include estimates of future prepayments of existing loans; they do not reflect costs associated with anticipated consolidation loans.

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Credit Program Receivables

The Department reclassified \$3.6 billion for FY2000 from liabilities for loan guarantees for FFEL to credit program receivables to align the allowance for subsidy to the expected value under credit reform. This reclassification did not result in program costs or additional subsidy. Credit program receivables are comprised of direct and defaulted FFEL loan principal and related interest receivable, net or inclusive of the allowance for subsidy. The credit program receivables are as follows:

Direct Loan Program Credit Program Receivables
at September 30
(Dollars in Thousands)

	<u>FY2001</u>	<u>FY2000</u>
Principal Receivable	\$ 70,544,902	\$ 58,522,455
Interest Receivable	2,615,855	1,707,927
Sub-total	\$ 73,160,757	\$ 60,230,382
Allowance for Subsidy	1,568,317	2,585,250
Credit Program Receivable, Net	\$ 74,729,074	\$ 62,815,632

The allowance for subsidy for Direct Loans is a negative (debit) balance due to high interest payment projections on Department receivables such that total projected principal and interest received will exceed the face value of the loan receivables.

FFEL Program Credit Program Receivables
at September 30
(Dollars in Thousands)

	<u>FY2001</u>			<u>FY2000</u>		
	<u>Pre-1992</u>	<u>Post-1991</u>	<u>Total</u>	<u>Pre-1992</u>	<u>Post-1991</u>	<u>Total</u>
Principal Receivable	\$14,120,871	\$5,366,538	\$19,487,409	\$14,986,951	\$5,341,825	\$20,328,776
Interest Receivable	1,740,152	1,286,825	3,026,977	2,006,678	1,188,792	3,195,470
Sub-total	\$15,861,023	\$6,653,363	\$22,514,386	\$16,993,629	\$6,530,617	\$23,524,246
Allowance for Subsidy	(14,488,687)	(2,438,910)	(16,927,597)	(14,086,594)	(2,186,537)	(16,273,131)
Credit Program Receivable, Net	\$ 1,372,336	\$ 4,214,453	\$ 5,586,789	\$ 2,907,035	\$4,344,080	\$ 7,251,115

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Direct Loan Program Reconciliation of Allowance for Subsidy

The reconciliation of allowance for subsidy for the Direct Loan Program follows:

Direct Loan Reconciliation of Allowance for Subsidy		
(Dollars in Thousands)		
	<u>FY2001</u>	<u>FY2000</u>
Beginning Balance, Allowance for Subsidy	\$2,585,250	(\$1,557,854)
Components of Subsidy Transfers		
Interest Rate Differential	\$2,204,550	\$1,880,221
Default, Net of Recoveries	(597,850)	(784,166)
Fees	243,567	341,472
Other	(811,259)	(368,877)
Current Year Subsidy Transfers from Program Account	\$1,039,008	\$1,068,650
Components of Subsidy Re-estimates		
Interest Rate Re-estimates	\$875,608	\$378,049
Technical and Default Re-estimates	(3,221,618)	2,486,229
Total Subsidy Re-estimates	\$(2,346,010)	\$2,864,278
Activity		
Fee Collections	\$(315,040)	\$(360,570)
Loan Cancellations ¹	342,897	89,793
Subsidy Allowance Amortization	161,748	459,522
Other	100,464	21,431
Total Activity	\$290,069	\$210,176
Ending Balance, Allowance for Subsidy	\$1,568,317	\$2,585,250

¹Loan cancellations include those loans where the primary borrower has died, become disabled or declared bankruptcy.

Liabilities for Loan Guarantees

Liabilities for loan guarantees represent the net present value of future projected cash flows, including principal and interest repayments. As such, these estimates vary significantly with changes in forecasting assumptions; particularly involving the interest rates charged to students, those paid to loan holders, and those used for discounting cash flows. The FY2001 and FY2000 liabilities were calculated using government-wide interest rate projections provided by the Office of Management and Budget.

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FFEL Program Reconciliation of Liabilities for Loan Guarantees

The FFEL Program loan guarantee liability reconciliation, associated with the FFEL Program loans guaranteed in the financing account is as follows:

FFEL Program Guarantee Liability Reconciliation
(Dollars in Thousands)

	<u>FY2001</u>	<u>FY2000</u>
Beginning Balance, Liability for Loan Guarantees	\$9,534,955	\$8,250,606
Components of Subsidy Transfers		
Interest Supplement Costs	\$2,671,860	\$2,816,347
Defaults, Net of Recoveries	954,195	1,267,680
Fees	(1,371,175)	(1,067,127)
Other	854,129	513,234
Current Year Subsidy Transfers from Program Account	\$3,109,009	\$3,530,134
Components of Subsidy Re-estimates		
Interest Rate Re-estimates	\$ (43,022)	\$ (412)
Technical and Default Re-estimates	(2,864,956)	(1,283,104)
Subsidy Re-estimates in Liability	\$(2,907,978)	\$(1,283,516)
Activity		
Interest Supplement Payments	\$(3,343,333)	\$(3,108,557)
Claim Payments	(2,568,548)	(1,858,902)
Fee Collections	1,392,343	1,254,210
Interest on Liability Balance	460,717	499,843
Other ¹	2,549,042	2,251,137
Total Activity	\$(1,509,779)	\$(962,269)
Ending Balance, Liabilities for Loan Guarantees	\$8,226,207	\$9,534,955
FFEL Liquidating Account Liabilities for Loan Guarantees	150,560	443,713
Total Liabilities for Loan Guarantees	\$8,376,767	\$9,978,668

¹Includes amounts recorded to the liability balance for defaults, adjustments and loan consolidation activity. The adjustments include reclassification between the Liability for Loan Guarantees and Allowance for Subsidy for FY 2001 and FY 2000.

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Subsidy Expense

Direct Loan and FFEL Program loan guarantee subsidy expenses are as follows:

Direct Loan Program Subsidy Expense		
For the Fiscal Years Ended September 30		
(Dollars in Thousands)		
	<u>FY2001</u>	<u>FY2000</u>
Interest Rate Differential	\$(2,204,550)	\$(1,880,221)
Defaults, Net of Recoveries	597,850	784,166
Fees	(243,567)	(341,472)
Other	811,259	368,877
Current Year Subsidy Transfers	\$(1,039,008)	\$(1,068,650)
Re-estimates	2,346,010	(2,864,278)
Direct Loan Subsidy Expense	\$1,307,002	\$(3,932,928)

FFEL Program Loan Guarantee Subsidy Expense		
For the Fiscal Years Ended September 30		
(Dollars in Thousands)		
	<u>FY2001</u>	<u>FY2000</u>
Interest Supplement Costs	\$ 2,671,860	\$ 2,816,347
Defaults, Net of Recoveries	954,195	1,267,680
Fees	(1,371,175)	(1,067,127)
Other	854,129	513,234
Current Year Subsidy Transfers	\$ 3,109,009	\$ 3,530,134
Re-estimates	(3,423,314)	(3,234,603)
FFEL Loan Guarantee Subsidy Expense	\$ (314,305)	\$ 295,531

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Subsidy Rates

The subsidy rates are used to compute each year's subsidy expense, disclosed on the Statement of Net Cost. The subsidy rates applicable to the 2001 loan cohort year are as follows:

Subsidy Rates Applicable to 2001 Loan Cohort Year					
	<u>Interest Differential</u>	<u>Defaults</u>	<u>Fees</u>	<u>Other</u>	<u>Total</u>
Direct Loan Program, Cohort 2001	(10.31%)	2.64%	(1.18%)	4.39%	(4.46%)
	<u>Interest Supplements</u>	<u>Defaults</u>	<u>Fees</u>	<u>Other</u>	<u>Total</u>
FFEL Program, Cohort 2001	7.79%	2.47%	(4.40%)	2.81%	8.67%

The subsidy rates disclosed pertain only to the cohort listed. These rates cannot be applied to direct or guaranteed loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new direct or guaranteed loans reported in the current year relate to disbursements of loans from both current and prior years' cohorts. Subsidy expense is recognized when direct loans are disbursed by the SFA or third-party lenders disburse guaranteed loans.

Facilities Loan Programs

The Department administers the College Housing and Academic Facilities Loans (CHAFL), College Housing Loans (CHL), and Higher Education Facilities Loans (HEFL) programs. From 1952 to 1993, these programs provided low-interest financing to institutions of higher education for the construction, reconstruction, and renovation of housing, academic, and other educational facilities. Since 1998, no new loans have been authorized.

The Department also administers the Historically Black Colleges and Universities (HBCU) Capital Financing program. Since 1992, this program has provided HBCUs with access to capital financing for the repair, renovation, and, in exceptional circumstances, the construction, or acquisition of facilities, equipment, and infrastructure through Federally insured bonds. The Department has authorized a designated bonding authority to provide for the operation of the program including making the loans to eligible institutions, charging interest, and providing for a schedule of repayments. A mandatory escrow account has been established to pay the principal and interest on bonds for loans that are in default. The credit program receivables are as follows:

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Facilities Loan Programs
at September 30
(Dollars in Thousands)

	<u>FY2001</u>	<u>FY2000</u>
Principal Receivable	\$481,608	\$504,976
Interest Receivable	7,426	9,342
Subtotal	\$489,034	\$514,318
Allowance for Subsidy	(106,109)	(108,375)
Credit Program Receivables, Net	\$382,925	\$405,943

The allocation of administrative expense is disclosed in note 13.

Note 5. Property and Equipment

Property, Plant and Equipment
at September 30
(Dollars in Thousands)

	Asset Cost		Accumulated Depreciation		Net Asset Value	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
IT Equipment	\$28,393	\$1,307	\$4,732	\$ --	\$23,661	\$1,307
Furniture and Fixtures	1,563	--	156	--	1,407	--
Building Improvements	173	--	17	--	156	--
Total	\$30,129	\$1,307	\$4,905	\$ --	\$25,224	\$1,307

Information Technology Equipment consists of computer hardware and related software. The majority of these costs represent the continuing acquisition and implementation of a new financial accounting system. Furniture and fixtures, and building improvements are related to the renovation and furnishing of new quarters for SFA.

The significant increase in capitalized amounts for FY2001 in comparison to FY2000 is related to a modification in capitalization policy. Prior to FY2001, the Department only capitalized bulk purchases with an acquisition cost of \$500,000 or more. Beginning in FY2001, the capitalization policy was modified to include the capitalization of single items with a cost of \$50,000 or more.

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Note 6. Borrowing from Treasury

Borrowing from Treasury at September 30 (Dollars in Thousands)						
	Direct Student Loans		Facilities Loans		Total	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
Beginning Balance	\$65,346,881	\$52,069,506	\$368,505	\$ 379,803	\$65,715,386	\$52,449,309
New Borrowing	20,703,739	16,346,598	2,374	--	20,706,113	16,346,598
Repayments	(8,861,515)	(3,069,223)	(111,779)	(298)	(8,973,294)	(3,069,521)
Reclassified as Payable to FFB	--	--	--	(11,000)	--	(11,000)
Ending Balance	\$77,189,105	\$65,346,881	\$259,100	\$368,505	\$77,448,205	\$65,715,386

The Department's debt to the U.S. Treasury was \$77.4 billion as of September 30, 2001 and \$65.7 billion as of September 30, 2000. The funds were borrowed to provide funding for the direct loan and facilities loan programs. The borrowing is authorized through indefinite permanent authority at interest rates set each year by the U.S. Treasury.

Borrowing authority is a budgetary resource that is realized when disbursed. The Department draws funds from the U.S. Treasury to finance the majority of its direct lending activity in accordance with its needs. Borrowing authority not realized during the year is carried over for use in the future to fund loans that have been obligated, but not disbursed. Unused Borrowing Authority as of September 30, 2001 and September 30, 2000 was as follows:

Unused Borrowing Authority from Treasury at September 30 (Dollars in Thousands)		
	FY2001	FY2000
Beginning Balance, Unused Borrowing Authority	\$4,770,736	\$1,505,188
Current Year Borrowing Authority	21,794,507	19,612,146
Realized Borrowing from the U.S. Treasury	(20,703,739)	(16,346,598)
Prior Year Unused borrowing Authority Cancelled	(2,318,678)	--
Ending Balance, Unused Borrowing Authority	\$3,542,826	\$4,770,736

Note 7. Payable to Treasury

At September 30, 2001 and 2000, the Department reported \$4.2 billion and \$7.9 billion as payable to the U.S. Treasury. For the FFEL liquidating account the Department includes a payable to Treasury equivalent to the net cash inflows for the remaining life of the program; for FY2001, this amount was \$1.5 billion, for FY2000 this amount was \$3.9 billion. A payable to Treasury is also included for the downward re-estimates of subsidy

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needs for the FFEL financing account. This amount was \$2.7 billion in FY2001 and \$4 billion in FY2000, respectively.

The Department pays downward subsidy re-estimates in the year they are executed in the Budget, usually the fiscal year following financial statement accrual. The payable to Treasury consisted of the following:

Payable to the Treasury at September 30 (Dollars In Thousands)		
	<u>FY2001</u>	<u>FY2000</u>
Future Excess Liquidating Account Collections – FFEL	\$1,506,429	\$3,850,017
FFEL Downward Subsidy Re-estimate	2,706,126	4,010,604
Ending Balance	\$4,212,555	\$7,860,621

Note 8. Payable to Federal Financing Bank

Public Law 102.325, the Higher Education Amendments of 1994, authorized the Department to issue bonds on behalf of the HBCU Capital Financing Program. To date, all bonds issued under this program have been purchased by the Federal Financing Bank (FFB). The Department reports the corresponding liability for full payment of principal and accrued interest as a payable to the FFB under rules established by the Credit Reform Act of 1990.

Payable to Federal Financing Bank at September 30 (Dollars in Thousands)		
	<u>FY2001</u>	<u>FY2000</u>
Beginning Balance	\$20,699	\$ --
Reclassified from Borrowing from Treasury	--	11,000
Borrowing	10,983	9,796
Repayments	(333)	(97)
Ending Balance	\$31,349	\$20,699

The level of borrowing increased moderately in FY2001. The difference in ending balances between FY2001 and FY2000 reflects the cumulative effect of net borrowing for both fiscal years.

Note 9. Other Liabilities

Other liabilities covered by budgetary resources include contractual services, administrative services, interagency agreement accruals, and suspense account balances.

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Other liabilities not covered by budgetary resources include accrued annual leave and FECA disability benefits.

Other Liabilities at September 30 (Dollars in Thousands)		
	FY2001	FY2000
Other Liabilities Covered by Budgetary Resources:		
Intragovernmental	\$ 40,839	\$112,562
Governmental	<u>332,764</u>	<u>186,424</u>
Total	\$373,603	\$298,986
Other Liabilities Not Covered by Budgetary Resources:		
Intragovernmental	\$ 4,018	\$250,261
Governmental	<u>48,500</u>	<u>44,734</u>
Total	\$ 52,518	\$294,995
Total Other Liabilities	\$426,121	\$593,981

Total other Intragovernmental liabilities (covered and not covered by budgetary resources) were \$44.8 million in FY2001 and \$362.8 million in FY2000. Total other Governmental liabilities (covered and not covered by budgetary resources) were \$381.3 million in FY2001 and \$231.2 million in FY2000.

Note 10. Accrued Grant Liability

The Department's accrued grant liability represents an estimate of the expenses incurred by grantees that have not yet been reimbursed. For FY2000, the total liability was estimated from data reported from a random sample of grant awards and allocated among the reporting groups based on the grant balance available at fiscal year-end. For FY2001, the sample of grant awards was selected at the reporting group level, making further allocation unnecessary. The accrued grant liability by reporting group is shown below:

Accrued Grant Liability at September 30 (Dollars in Thousands)		
	FY2001	FY2000
SFA	\$ 899,180	\$ 319,376
OESE	298,202	752,098
OSERS	303,824	486,687
OVAE	45,419	137,219
OPE	187,077	179,749
OERI	61,934	80,245
OBEMLA	<u>59,304</u>	<u>50,755</u>
Total	\$1,854,940	\$2,006,129

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Note 11. Net Position

Net position is comprised of two elements – unexpended appropriations and cumulative results of operations. Unexpended appropriations represent appropriations not yet expended, which have not lapsed, been withdrawn, or rescinded. Balances not available are those that are non-apportioned for use by OMB. The Department’s unexpended appropriations consist of unobligated balances - available, unobligated balances – not available, and undelivered orders. The Department’s unexpended appropriations as of September 30, 2001 and September 30, 2000, are summarized as follows:

Unexpended Appropriations at September 30 (Dollars in Thousands)		
	FY2001	FY2000
Unobligated		
Available	\$ 2,209,285	\$ 1,795,131
Not Available	283,903	566,462
Undelivered Orders	28,198,629	24,361,167
Total	\$30,691,817	\$26,722,760

Undelivered orders and unobligated balances for federal credit financing and liquidating funds are not included in the chart above, as they are not funded through appropriations. As a result, unobligated and undelivered order balances in the above chart will differ from these balances contained in the Combined Statement of Budgetary Resources.

The Department had Cumulative Results of Operations of (\$2) billion as of September 30, 2001 and (\$124) million as of September 30, 2000. Cumulative results of operations arise from unfunded expenses, capital equipment purchases, reimbursable agreements, and upward loan subsidy re-estimates. The FY2001 and FY2000 re-estimate for direct loans were recorded as net upward re-estimates, reducing cumulative results of operations. The net upward re-estimates for direct loans for FY2001 and FY2000 were \$2.1 billion and \$250 million, respectively. Accordingly, the cumulative results of operations for FY2001 and FY2000 reflect the net upward re-estimate in those years.

Note 12. Interest Revenue and Expense

For the Direct Loan program, non-federal interest revenue is earned on the individual non-defaulted loans in the loan portfolio and federal interest is earned on the uninvested fund balances with the U.S. Treasury. Also, for the Direct Loan program, interest expense is incurred on the Department’s borrowings from the U.S. Treasury. For the FFEL program, federal interest revenue is earned on the uninvested fund balance with the U.S. Treasury. The interest revenues and expenses directly attributable to the Direct Loan Program, the FFEL Program, and other remaining programs are summarized below:

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Interest Revenue and Expenses
For Fiscal Years Ended September 30
(Dollars in Thousands)

	Direct Student Loans		FFEL Program		Other Programs		Total	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
Interest Revenue								
Federal	\$1,061,471	\$1,261,281	\$460,717	\$499,843	\$ 183	\$ 161	\$1,522,371	\$1,761,285
Non-Federal	4,039,690	3,211,256	--	--	18,561	23,067	4,058,251	3,234,323
Total Interest Revenue	\$5,101,161	\$4,472,537	\$460,717	\$499,843	\$ 18,744	\$23,228	\$5,580,622	\$4,995,608
Interest Expense								
Federal	\$5,101,161	\$4,472,537	\$460,717	\$499,843	\$16,167	\$20,933	\$5,578,045	\$4,993,313
Non-Federal	183	115	159	109	69	81	411	305
Total Interest Expense	\$5,101,344	\$4,472,652	\$460,876	\$499,952	\$16,236	\$21,014	\$5,578,456	\$4,993,618

Note 13. Allocation of Direct and Indirect Cost

The reported salaries and administrative expenses include the allocation of direct and indirect administrative costs among the reporting groups. The distribution is calculated based on a combination of full time employees and program costs.

Allocation of Administrative Expenses
For Fiscal Years Ended September 30
(Dollars in Thousands)

	Direct Costs		Indirect Costs		Total Costs	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
SFA	\$52,998	\$50,580	\$72,263	\$63,131	\$125,261	\$113,711
OSERS	32,300	32,182	30,270	22,628	62,570	54,810
OCR	(3)	--	34,852	30,076	34,849	30,076
OERI	36,537	34,806	16,203	14,304	52,740	49,110
OESE	24,284	23,304	34,523	23,124	58,807	46,428
OPE	24,981	25,878	14,441	12,468	39,422	38,346
OBEMLA	3,941	3,729	2,914	2,569	6,855	6,298
OVAE	10,968	9,943	8,878	7,077	19,846	17,020
Total	\$186,006	\$180,422	\$214,344	\$175,377	\$400,350	\$355,799

Note 14. Imputed Financing

The Statement of Changes in Net Position recognized an imputed financing source of \$20.6 million for the year ended September 30, 2001, and \$20.8 million for the year ended September 30, 2000. Corresponding post-employment benefit expenses are recognized on the Statement of Net Cost as a program cost under salaries and administrative expense for both fiscal years. The imputed financing source represents annual service costs not paid by the Department or employee contributions to the Civil Service Retirement System. No imputed financing source is recognized for the Federal

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Employees Retirement System, since it is a fully funded retirement service plan. The post-employment benefit expense represents the Department's estimate of the funds necessary to pay employees future pension, life, and health benefits.

Note 15. Prior Period Adjustments

During FY2001 and FY2000, the Department performed various analyses of its account balances in an effort to improve the financial data recorded in its accounting system. Items of income and expense related to prior periods were recorded as prior period adjustments and Net Position was amended to reflect the adjustments.

Prior Period Adjustments to Net Position		
For Fiscal Years Ended September 30		
(Dollars in Thousands)		
	FY2001	FY2000
FFEL	\$ 69	(\$824,645)
DL	50	(20,694)
SFA Grants	(48,462)	(85,716)
OESE	(98,942)	(3,701)
OSERS	(2,095)	63,372
OVAE	223	3,824
OPE	44,424	(59,631)
OERI	(13,031)	27,935
OBEMLA	(220)	(10,191)
DM	(34,845)	35,863
Total	(\$152,829)	(\$873,584)

During FY2001, the Department made prior period adjustments to:

- Adjust cumulative results of operations account balances based on an analysis of unfunded liabilities and capitalized assets.
- Align Fund Balance with Treasury and budgetary accounts comprising unobligated balances, undelivered orders, and accounts payable and receivable.
- Align subsidiary systems to general ledger balances

During FY2000, the Department reconciled its undelivered order balances between its general ledger and the GAPS payment system, disbursement in transit account balances, and its Fund Balance with Treasury to the budgetary status of resource accounts. In addition, it reviewed the FFEL financing fund to correct the cumulative results of operations account balance. Prior period adjustments were made based on these analyses.

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Note 16. Unobligated and Obligated Balances – Beginning of Period

During FY2001 and FY2000, the Department performed a review of unobligated and obligated balances and recorded adjustments to the beginning account balances. The statement of budgetary resources reflects the adjusted beginning unobligated and obligated balances, and the related adjustments to obligations incurred during the period.

The FY2001, adjustments to the beginning obligated balances resulted from an analysis of the budgetary and proprietary accounts payable balances. Adjustments to the prior year's posting logic resulted in changes to the beginning obligated balances. Additionally, the FY2001 beginning obligated and unobligated balances were adjusted due to systematic problems in the general ledger closing process and other accounting problems that occurred in prior years.

The beginning unobligated balance was adjusted downward by \$16.3 million in FY2001 and adjusted upward by \$611 million in FY2000, while the beginning obligated balance was adjusted downward by \$227.1 million in FY2001 and adjusted upward by \$798 million in FY2000. The obligations incurred balance was adjusted upward by \$229 million in FY2001 and adjusted downward by \$798 million in FY2000.

The reconciliations are shown below:

Unobligated Balances – Beginning of Period at September 30 (Dollars in Thousands)						
	Beginning Balance (Unadjusted)		Adjustments		Beginning Balance (Adjusted)	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
FFEL	\$8,173,288	\$7,771,917	\$6,774	\$498,922	\$8,180,062	\$8,270,839
DL	22,960	29,794	(17,969)	--	4,991	29,794
SFA Grants	1,652,835	4,720,204	41,184	182,208	1,694,019	4,902,412
OESE	168,984	349,420	(31,661)	(43,763)	137,323	305,657
OSERS	286,040	176,630	(288)	(7,741)	285,752	168,889
OVAE	89,588	68,870	577	(9)	90,165	68,861
OPE	118,650	80,431	(324)	(986)	118,326	79,445
OERI	6,579	22,278	3,147	(120)	9,726	22,158
OBEMLA	2,847	3,682	--	--	2,847	3,682
DM	24,212	30,209	(17,768)	(17,675)	6,444	12,534
Total	\$10,545,983¹	\$13,253,435	\$(16,328)	\$610,836	\$10,529,655	\$13,864,271

¹The difference between the FY2000 ending unobligated balance and the FY2001 beginning unobligated (unadjusted) balance is the result of a \$24 million transfer of a prior year unobligated balance to the Department of Labor.

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**Obligated Balances – Beginning of Period
at September 30
(Dollars in Thousands)**

	Beginning Balance (Unadjusted)		Adjustments		Beginning Balance (Adjusted)	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
FFEL	\$3,878,875	\$3,060,836	\$(170,661)	\$745,255	\$3,708,214	\$3,806,091
DL	7,229,151	6,907,766	2,291	--	7,231,442	6,907,766
SFA Grants	6,510,518	2,807,498	16,126	143,208	6,526,644	2,950,706
OESE	8,825,209	9,751,345	(15,839)	(76,228)	8,809,370	9,675,117
OSERS	5,118,981	7,868,327	1,435	(3,320)	5,120,416	7,865,007
OVAE	1,271,965	1,912,742	726	11	1,272,691	1,912,753
OPE	1,994,678	1,572,427	1048	(4)	1,995,726	1,572,423
OERI	732,133	704,807	(6,926)	(10,610)	725,207	694,197
OBEMLA	557,130	529,117	263	--	557,393	529,117
DM	220,591	253,153	(55,592)	65	164,999	253,218
Total	\$36,339,231	\$35,368,018	\$(227,129)	\$798,377	\$36,112,102	\$36,166,395

**Obligations Incurred
at September 30
(Dollars in Thousands)**

	Beginning Balance (Unadjusted)		Adjustments		Beginning Balance (Adjusted)	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
FFEL	\$15,004,142	\$11,560,310	\$170,661	\$(745,255)	\$15,174,803	\$10,815,055
DL	27,882,115	24,521,127	(2,291)	--	27,879,824	24,521,127
SFA Grants	11,709,192	12,921,838	(14,024)	(143,208)	11,695,168	12,778,630
OESE	16,648,985	13,279,508	15,839	76,228	16,664,824	13,355,736
OSERS	9,223,684	5,020,339	(1,435)	3,320	9,222,249	5,023,659
OVAE	\$1,850,617	866,315	(726)	(11)	1,849,891	866,304
OPE	2,175,184	1,839,809	(1,048)	4	2,174,136	1,839,813
OERI	727,456	591,954	6,926	10,610	734,382	602,564
OBEMLA	458,380	405,808	(263)	--	458,117	405,808
DM	476,124	488,469	55,592	(65)	531,716	488,404
Total	\$86,155,879	\$71,495,477	\$229,231	\$(798,377)	\$86,385,110	\$70,697,100

Note 17. Statement of Budgetary Resources

The Statement of Budgetary Resources compares budgetary resources with the status of those resources. As of September 30, 2001, budgetary resources outstanding were \$94.1 billion and outlays for the year were \$52.3 billion. As of September 30, 2000, budgetary resources outstanding were \$81.3 billion and outlays for the year were \$48.6 billion.

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Budgetary Resources

Borrowing authority is a budgetary resource used to fund loans made under the Federal Direct Student Loan Program. Borrowing authority is granted to a federal entity to borrow, obligate and expend the borrowed funds. This program may borrow from Treasury to fund loans originated during the year. Borrowings may be repaid to Treasury at any time without penalty and funds not expended accrue interest as uninvested funds. The majority of the funds used to repay Treasury borrowings are from collections on outstanding loans.

The Federal Direct Student Loan Program and the FFEL Program were granted permanent indefinite appropriation budget authority through legislation. Part D of the William D. Ford Federal Direct Loan Program and Part B of the Federal Family Education Loan Program, pursuant to the HEA of 1965, pertains to the existence, purpose, and availability of this permanent indefinite appropriations authority.

Adjustments

The “Adjustments” line item on the Statement of Budgetary Resources primarily includes repayments of borrowings, negative subsidy returns, and excess collections returned to Treasury.

Adjustments for Direct Loans totaled \$8.3 billion in FY2001, consisting of transactions in the Financing fund and in the Program fund. In the Financing fund, repayments to Treasury totaled \$6.6 billion. In the Program fund, \$1.7 billion of collections from the downward re-estimate/negative subsidy were returned to the Treasury Department.

Adjustments to FFEL totaled \$5.9 billion in FY2001, consisting of transactions in the Liquidating fund and in the Program fund. In the Liquidating fund, excess collections to Treasury totaled \$1.6 billion. In the Program fund, capital transfers (repayment of downward re-estimate to Treasury) totaled \$5.1 billion, offset by approximately \$800 million in recoveries.

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Obligated Balances

The budgetary resources obligated balances, by reporting group, as of September 30, 2001 and September 30, 2000 are summarized below:

Obligated Balances at September 30 (Dollars in Thousands)		
<u>Reporting Group</u>	<u>FY2001</u>	<u>FY2000</u>
SFA	\$13,985,723	\$17,618,544
OES	11,004,528	8,825,209
OSERS	5,517,160	5,118,981
OVAE	1,495,821	1,271,965
OPE	2,442,766	1,994,678
OERI	878,229	732,133
OBEMLA	603,438	557,130
DM	159,554	220,591
Total	\$36,087,219	\$36,339,231

The Department adjusted its obligated balances for the direct loan program downward by \$4.6 billion in FY2001, as these amounts are no longer needed. This downward adjustment of obligations resulted in the return of \$2.3 billion in unused borrowing authority and the repayment of \$2.3 billion in outstanding borrowing from Treasury.

Comparison to the Budget of the United States Government

Differences exist between the Statement of Budgetary Resources and the FY 2001 actual amounts reported in the Budget of the United States Government. These differences are not material and relate to the use of all appropriations (current and expired) for the Statement of Budgetary Resources versus only current year appropriations for the Budget of the United States Government. In addition, the Budget of the United States Government includes information and estimates that pre-date the completion of the Department's audited financial statements.

Note 18. Statement of Financing

The Statement of Financing provides information on the total resources used by an agency, both those received through appropriation and those received through other means during the reporting period. It then explains how they were used in agency operations to finance orders for goods and services not yet delivered, to acquire assets and liabilities, and to fund the entity's net cost of operations.

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Cash flows associated with credit programs, flow through the liability for loan guarantees or the allowance for subsidy. These flows, unlike other accounts, are not recorded as revenues or expenses and do not affect the Department's net cost of operations. Special circumstances surround unfunded expenses such as upward subsidy re-estimates, accrued annual leave, and other payroll-related accruals. These unfunded expenses affect the Statement of Net Cost but are not covered by budgetary resources, (i.e. do not give rise to a budgetary accounting event). Liabilities not covered by budgetary resources were \$52.5 million and \$295 million, for FY2001 and FY2000, respectively.

The Statement of Financing is presented as a combined statement for the Department and as a combining statement for its major programs. The net cost of operations, by reporting group, for FY2001 and FY2000 is shown below:

Net Cost of Operations		
For Fiscal Years Ended September 30		
(Dollars in Thousands)		
<u>Reporting Group</u>	<u>FY2001</u>	<u>FY2000</u>
SFA	\$12,746,464	\$6,234,813
OESE	13,947,813	13,828,926
OSERS	8,672,602	8,176,263
OVAE	1,549,502	1,608,749
OPE	1,718,380	1,542,678
OERI	603,784	715,758
OBEMLA	416,350	409,166
DM	153,068	202,471
Total	\$39,807,963	\$32,718,824

Note 19. Cost and Revenue by Budget Function

The Department's costs and revenue, by budget function, are presented below:

Cost and Revenue by Budget Function						
For Fiscal Years Ended September 30						
(Dollars in Thousands)						
	Gross Costs		Earned Revenue		Net Costs	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
Education, training, employ-, ment and social services	\$45,250,503	\$37,666,354	\$5,586,644	\$5,086,278	\$39,663,859	\$32,580,076
Administration of justice	144,235	138,918	131	170	144,104	138,748
Total	\$45,394,738	\$37,805,272	\$5,586,775	\$5,086,448	\$39,807,963	\$32,718,824

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Note 20. Contingencies

Guaranty Agencies

The Department can assist Guaranty Agencies experiencing financial difficulties by advancing funds or by other means. No provision has been made in the principal statements for potential liabilities related to financial difficulties of Guaranty Agencies because the likelihood of such occurrences is uncertain and cannot be estimated with sufficient reliability.

Perkins Loans Reserve Funds

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. The Department provides funds to participating schools to provide about 85.5 percent of the capital used to make loans to eligible students at 5 percent interest. The remaining 14.5 percent of program funding is provided by the school. For the latest academic year ended June 30, 2001, there were approximately 620,000 loans made, totaling approximately \$1.1 billion at approximately 1,761 institutions, averaging \$1,790 per loan. For the academic year ended June 30, 2000, there were approximately 653,000 loans made, totaling approximately \$1.1 billion at approximately 1,817 institutions, averaging \$1,700 per loan. The Department's share of the Perkins Loan Program was approximately \$6.1 billion as of September 30, 2001; and approximately \$6.2 billion as of September 30, 2000.

Perkins Loan borrowers who meet statutory eligibility requirements—such as service as a teacher in low income areas, as a Peace Corps or VISTA volunteer, in the military, or in law enforcement, nursing, or family services—may receive partial loan forgiveness for each year of qualifying service. In these circumstances a contingency exists. The Department may be required to compensate Perkins Loan institutions for the cost of the partial loan forgiveness.

Litigation and Other Claims

The Department is involved in various lawsuits incidental to its operations. Judgments resulting from litigation against the Department are paid by the Department of Justice. In the opinion of management, the ultimate resolution of pending litigation will not have a material effect on the Department's financial statements.

Other Matters

Some portion of the current year financial assistance expenses (grants) may include funded recipient expenditures which were subsequently disallowed through program review or audit processes. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Department's financial statements.

INVESTMENT IN HUMAN CAPITAL

The U. S. Department of Education (ED) executes programs under the Education, Training, Employment and Social Services function established by Congress in the Budget Act of 1974. This report presents Human Capital activity related to the execution of the ED's congressionally approved budget and programs.

NARRATIVE DISCUSSION

The Department of Education's mission is to ensure equal access to education and to promote educational excellence throughout the nation. To carry out this mission, the Department works in partnership with states, schools, communities, institutions of higher education and financial institutions--and through them with students, teachers and professors, families, administrators, and employers. Key functions of the partnership are:

- Leadership to address critical issues in American education.
- Grants to education agencies and institutions to strengthen teaching and learning and prepare students for citizenship, employment in a changing economy, and lifelong learning.
- Student loans and grants to help pay for the costs of postsecondary education.
- Grants for literacy, employment, and self-sufficiency training for adults.
- Monitoring and enforcement of civil rights to ensure nondiscrimination by recipients of federal education funds.
- Support for statistics, research, development, evaluation, and dissemination of information to improve educational quality and effectiveness.

HUMAN CAPITAL PROGRAMS

Federal investment in Human Capital comprises those expenses for general public education and training programs that are intended to increase or maintain national economic productive capacity. The Department of Education's Human Capital programs include Elementary and Secondary, Postsecondary, Student Financial Assistance, Special and Rehabilitative Education, Research and Improvement, Bilingual and Minority Languages, and Vocational and Adult Education.

Elementary and Secondary Education

The Office of Elementary and Secondary Education provides leadership, technical assistance, and financial support to State and local educational agencies for maintenance and improvement of preschool, elementary, and secondary education.

Compensatory Education Programs provide financial assistance to State and local education agencies and other institutions to support services for children in high poverty schools, institutions for neglected and delinquent children, homeless children, and certain Indian children.

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The Comprehensive School Reform Demonstration Program provides grants to States to help public schools adopt or develop effective comprehensive school reforms with an emphasis on basic academics and parental involvement.

Goals 2000 Programs provide grants to support State and local district efforts to improve schools and parental involvement in schools so all children can reach challenging academic standards.

The Impact Aid Program provides financial assistance for the maintenance and operations of school districts in which the Federal Government has acquired substantial real property. It provides direct assistance to local educational agencies that educate substantial numbers of federally connected pupils (children who live on, or whose parents work on, federal property).

Indian Education supports the efforts of local educational agencies, Indian tribes, and other entities to meet the academic needs of American Indians and Alaska Natives so these students can achieve to the same State performance standards as all students.

Migrant Education Programs support high-quality comprehensive educational programs for migratory children to address disruptions in schooling and other problems that result from repeated moves.

Safe and Drug-Free Schools Programs provide leadership to ensure that all schools are free of drugs and violence and the unauthorized presence of firearms and alcohol and that all schools offer a disciplined environment that is conducive to learning.

School Improvement Programs provide financial assistance to State and Local Educational Agencies, institutions of higher education, and other public and private nonprofit organizations for general assistance, projects to meet special educational needs of target children and teacher development.

Class Size Reduction Program is an initiative to help schools improve student learning by hiring additional, highly qualified teachers so children — especially those in the early elementary grades — can attend smaller classes.

The 21st Century Community Learning Centers Program provides support to after-school projects that keep children safe and provide academic enrichment and other recreational and enrichment opportunities such as band, drama, art, and other cultural events for children. It also provides life-long learning opportunities for community members.

The Community Technology Centers Program expands access to information technology and learning services by creating computer learning centers in low-income

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communities. The centers are used for pre-school preparation, workforce development, after-school enrichment, and adult and continuing education.

The Reading Excellence Program helps children learn to read through instruction based on research, professional development, family literacy, and extended learning activities.

Postsecondary Education

The Office of Postsecondary Education formulates policy and coordinates programs that assist postsecondary educational institutions and students pursuing a postsecondary education.

Policy, Planning, and Innovation supports The Fund for the Improvement of Postsecondary Education, which provides grants to colleges and universities to promote reform, innovation, and improvement in postsecondary education.

Higher Education Programs (HEP) administer discretionary funds and provide support services that improve student access to postsecondary education and foster excellence in institutions of higher education.

Learning Anytime Anywhere Partnerships (LAAP) - The Office of Postsecondary Education supports partnerships among colleges, businesses, and other organizations to promote technology-mediated distance education that is not limited by time or place.

Student Financial Assistance (SFA) Programs

SFA administers need-based financial assistance programs for students pursuing postsecondary education. ED makes available federal grants, loans and work-study funding to eligible undergraduate and graduate students.

ED's two major loan programs are the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Student Loan Program. The FFELP operates with State and private nonprofit guaranty agencies to provide loan guarantees and interest supplements through permanent budget authority on loans by private lenders to eligible students. The William D. Ford Direct Student Loan Program is a direct lending program in which loan capital is provided to students by the Federal Government through borrowing from the U.S. Treasury.

Special Education and Rehabilitative Services

The Office of Special Education and Rehabilitative Services supports programs that assist in educating children with special needs. It provides for the rehabilitation of youth and adults with disabilities and supports research to improve the lives of individuals with disabilities.

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The Office of Special Education Programs administers programs and projects relating to the free public education of all children, youth, and adults with disabilities from birth through age 21.

Rehabilitation Services Administration (RSA) oversees programs such as counseling, medical and psychological services, job training, and other individualized services that help individuals with physical or mental disabilities to obtain employment.

The National Institute on Disability and Rehabilitation provides leadership and support for a comprehensive program of research related to the rehabilitation of individuals with disabilities.

Educational Research and Improvement

The Office of Educational Research and Improvement (OERI) is responsible for expanding America's fundamental knowledge and understanding of education through research and development.

Media and Information Services (MIS) provides leadership in developing effective media and information services for OERI.

The National Center for Education Statistics fulfills a Congressional mandate to collect, collate, analyze, and report complete statistics on the condition of American education, conduct and publish reports, and review and report on education activities internationally.

The National Institute on Early Childhood Development and Education administers a comprehensive program of research and development to improve early childhood development and education.

The National Institute on the Education of At-Risk Students administers a comprehensive program of research and development for the improvement of education for at-risk students (defined as those who because of limited English proficiency, poverty, race, geographic location, or economic disadvantage face a greater risk of low education achievement or reduced academic expectations).

The National Institute on Educational Governance, Finance, Policymaking, and Management develops and disseminates information to guide the design and implementation of effective governance strategies.

The National Institute on Postsecondary Education, Libraries, and Lifelong Learning provides information about the education and training of adults in a variety of settings including postsecondary institutions, community-based education programs, libraries, and the workplace.

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The National Institute on Student Achievement, Curriculum, and Assessment administers a comprehensive program of research and development to provide leadership for states and localities to improve student achievement and enhance student learning.

The National Library of Education (NLE) is the largest federally funded library devoted entirely to education. NLE serves in three areas: Reference and Information Services, Collection and Technical Services, and Resource Sharing and Cooperation.

The Office of Reform Assistance and Dissemination supports comprehensive education reform by linking teachers, administrators, parents, policymakers, and the public with the best knowledge from education research, statistics, and practice.

Bilingual and Minority Languages

The Office of Bilingual Education and Minority Languages Affairs helps school districts meet their responsibility to provide equal education opportunity to limited English proficient children.

Office of Vocational and Adult Education

The Office of Vocational and Adult Education provides funds for vocational-technical education for youth and adults. Most of the funds are awarded in the form of grants to State education agencies.

STEWARDSHIP EXPENSES

In the Department of Education, discretionary spending constitutes approximately 90 percent of the budget and includes nearly all programs, the major exceptions being student loans and rehabilitation services. While spending for entitlement programs is usually a function of the authorizing statutes creating the programs, and is not generally affected by appropriations laws, spending for discretionary programs is decided in the annual appropriations process. Most Department programs are discretionary - for example, Impact Aid, Vocational Education, Special Education, Pell Grants, Research, and Statistics.

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Summary of Human Capital Expenses

(Dollars in thousands)

Student Financial Assistance	FY 2001	FY 2000
Direct Loan Subsidy Expense	\$ 1,307,001	\$(3,932,928)
Guaranteed Loan Subsidy Expense	(314,305)	295,531
Grant Program Expense	10,812,779	8,960,280
Salaries & Administrative Expense	248,945	273,866
Subtotal	\$12,054,420	\$ 5,596,749

Other Departmental

Elementary and Secondary Education Expense	\$13,850,422	\$13,773,266
Special Education & Rehabilitative Services Expense	8,590,455	8,104,963
Other Departmental Program Expense	3,892,814	3,955,390
Salaries & Administrative Expense	341,074	312,051
Subtotal	\$26,674,765	\$26,145,670

Grand Total	\$38,729,185	\$31,742,419
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Intra-Governmental Amounts (Dollars in thousands)

Assets	FY 2001	FY 2000
Fund Balance With Treasury	\$40,476,338	\$42,160,719
Accounts Receivable	10,730	--
Interest Receivable	57	70,755
Total Assets	\$40,487,125	\$42,231,474

Liabilities

Borrowing from Treasury	\$77,448,205	\$65,715,386
Payable to Treasury	4,212,555	7,860,621
Guaranty Agency Federal & Restricted Funds due to Treasury	2,462,445	2,231,814
Payable to Federal Financing Bank	31,349	20,699
Accounts Payable	22,293	6,647
Interest Payable	7,866	83,469
Other Intra-Governmental Liabilities Covered by Budgetary Resources	40,839	112,562
Other Intra-Governmental Liabilities Not Covered by Budgetary Resources	4,018	250,261
Total Liabilities	\$84,229,570	\$76,281,459

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PROGRAM OUTPUTS

Education is primarily a State and local responsibility in the United States. States and communities, as well as public and private organizations, establish schools and colleges, develop curricula, and determine requirements for enrollment and graduation. The structure of education finance in America reflects this predominantly State and local role. Combining ED's expenditures of roughly \$42 billion a year with funding from all other federal agencies, such as the Department of Health and Human Services' Head Start program and the Department of Agriculture's School Lunch program, the Federal Government contributes approximately 9 percent of total national expenditures on education. The remaining 91 percent comes from State, local, and private sources. That \$42 billion is about 1.9 percent of the Federal Government's \$1.9 trillion budget.

ED currently administers 174 programs affecting every area and level of education. The Department's elementary and secondary programs annually serve 15,000 school districts and more than 50 million students attending almost 85,000 public schools and more than 26,000 private schools. Department programs also provide grant, loan, and work-study assistance to more than 8 million postsecondary students.

While ED's programs and responsibilities have grown substantially over the years, the Department itself has not. In fact, ED's staff of 4,700 is nearly 40 percent below the 7,500 employees who administered Federal education programs in 1980, the year the Department was created. These staff reductions, along with a wide range of management improvements, have helped limit administrative costs to less than 3 percent of the Department's budget. This means that ED delivers about 97 cents on the dollar in education assistance to States, school districts, postsecondary institutions, and students.

PROGRAM OUTCOMES

Education is the stepping stone to higher living standards for American citizens. Education is key to national economic growth. But education's contribution is more than increased productivity and incomes. Education improves health, promotes social change and opens doors to a better future for children and adults.

Economic outcomes, such as wage and salary levels, historically have been determined by the educational attainment of individuals and the skills employers expect of those entering the labor force. Recently, both individuals and society as a whole have placed increased emphasis on educational attainment as the workplace has become increasingly technological and employers now seek employees with the highest level of skills. For prospective employees, the focus on higher level skills means investing in learning or developing skills through education. Like all investments, developing higher level skills involves costs and benefits.

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Returns, or benefits, of investing in education come in many forms. While some returns accrue for the individual, others benefit society and the Nation in general. Returns related to the individual include higher earnings, better job opportunities, and jobs that are less sensitive to general economic conditions. Returns related to the economy and society include reduced reliance on welfare subsidies, increased participation in civic activities, and greater productivity.

Over time, the returns of developing skills through education have become evident. Statistics illustrate the rewards of completing high school and investing in postsecondary education:

- **Employment Rate:** Between 1971 and 1998, the employment rate of male and female 25 to 34 year-olds was generally higher among those individuals with a higher level of education. The employment rate of males ages 25 to 34 decreased for those who had not finished high school and those with a high school diploma or GED, and remained relatively constant for those with some college and those with a bachelor's degree or higher. The employment rate of females ages 25 to 34 increased across all education levels. However, the rate of increase for females who did not complete high school was lower than the rate of increase for females who attained higher levels of education.
- **Annual Earnings:** In 1998, the median annual earnings of adults ages 25 to 34 who had not completed high school were substantially lower than those of their counterparts who had done so (30 and 31 percent lower for males and females, respectively). Adults ages 25 to 34 who had completed a bachelor's degree or higher earned substantially more than those who had less education (56 and 100 percent more for males and females, respectively).

These returns of investing in education directly translate into the advancement of the American economy as a whole.

SUPPLEMENTARY
INFORMATION

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Consolidating Balance Sheet
As of September 30, 2001
(Dollars in Thousands)

Assets	Consolidated	Student Financial Assistance	Office of Elementary & Secondary Education	Office of Special Education & Rehabilitative Services	Office of Vocational & Adult Education	Office of Postsecondary Education	Office of Educational Research & Improvement	Office of Bilingual Education & Minority Languages	Department Management
Intragovernmental Assets:									
Fund Balance with Treasury (Note 2)	\$40,476,338	\$17,196,330	\$11,734,211	\$5,659,539	\$1,562,591	\$2,450,010	\$884,121	\$608,471	\$381,065
Accounts Receivable, Net (Note 3)	10,730	4,488	150	1,957			261		3,874
Interest Receivable	57					57			
Governmental Assets:									
Accounts Receivable, Net (Note 3)	113,083	111,469				1,498			116
Credit Program Receivables, Net (Note 4)	80,698,787	80,315,862				382,925			
Advances	38,738	38,738							
Cash and Other Monetary Assets									
Property and Equipment (Note 5)	25,224	17,307					535		7,382
Other Governmental Assets	259,945	258,006				1,896			43
Guaranty Agency Federal & Restricted Funds Receivable (Note 3)	2,462,445	2,462,445							
Total Assets	\$124,085,347	\$100,404,645	\$11,734,361	\$5,661,496	\$1,562,591	\$2,836,386	\$884,917	\$608,471	\$392,480
Liabilities									
Intragovernmental Liabilities:									
Accounts Payable	\$22,293	\$3,410	\$9,564	\$1,512	\$82	\$48	\$5,541	\$8	\$2,128
Interest Payable	7,866					7,866			
Borrowing from Treasury (Note 6)	77,448,205	77,189,105				259,100			
Guaranty Agency Federal & Restricted Funds Due To Treasury (Note 3)	2,462,445	2,462,445							
Payable to Treasury (Note 7)	4,212,555	4,212,555							
Payable to Federal Financing Bank (Note 8)	31,349					31,349			
Other Intragovernmental Liabilities (Note 9)	44,857	980	193	276	104	390	286	34	42,594
Governmental Liabilities:									
Accounts Payable	590,921	516,097	19,211	15,356	4,060	7,076	10,627	876	17,618
Accrued Grant Liability (Note 10)	1,854,940	899,180	298,202	303,824	45,419	187,077	61,934	59,304	
Liabilities for Loan Guarantees (Note 4)	8,376,767	8,376,767							
Other Governmental Liabilities (Note 9)	381,264	119,937	9,312	5,589	2,755	5,056	20,001	965	217,649
Total Liabilities	\$95,433,462	\$93,780,476	\$336,482	\$326,557	\$52,420	\$497,962	\$98,389	\$61,187	\$279,989
Net Position									
Unexpended Appropriations (Note 11)	\$30,691,817	\$8,738,794	\$11,400,664	\$5,335,102	\$1,511,642	\$2,241,554	\$790,474	\$547,781	\$125,806
Cumulative Results of Operations (Note 11)	(2,039,932)	(2,114,625)	(2,785)	(163)	(1,471)	96,870	(3,946)	(497)	(13,315)
Total Net Position	\$28,651,885	\$6,624,169	\$11,397,879	\$5,334,939	\$1,510,171	\$2,338,424	\$786,528	\$547,284	\$112,491
Total Liabilities and Net Position	\$124,085,347	\$100,404,645	\$11,734,361	\$5,661,496	\$1,562,591	\$2,836,386	\$884,917	\$608,471	\$392,480

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Consolidating Statement of Net Cost
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Consolidated	Student Financial Assistance	Office of Elementary & Secondary Education	Office of Special Education & Rehabilitative Services	Office of Vocational & Adult Education	Office of Postsecondary Education	Office of Educational Research & Improvement	Office of Bilingual Education & Minority Languages	Department Management
Program Costs									
Intragovernmental									
Interest Expense, Federal (Note 12)	\$5,578,045	\$5,561,878				\$16,167			
Other Production Expense									
Grant Expense	71,180		\$69,954		\$50		\$1,176		
Contractual Service Expense	81,349	12,869	10,779	\$4,008	10,042	4,259	34,594	\$276	\$4,522
Salaries and Administrative Expense (Note 13)	153,433	95,518	5,854	7,142	3,062	5,984	8,449	909	26,515
Bad Debt & Write-offs	38		37						1
Other Program Expenses									
Governmental									
Subsidy Expense (Note 4)	999,287	992,696				6,591			
Grant Expense	37,068,699	10,812,779	13,780,468	8,590,455	1,501,867	1,655,321	323,867	403,901	41
Interest Expense, Non-Federal (Note 12)	411	358		6			8		39
Contractual Service Expense	805,532	484,012	38,507	27,473	17,160	18,778	193,855	5,973	19,774
Salaries and Administrative Expense (Note 13)	436,586	153,427	42,231	47,628	17,322	29,438	41,860	5,291	99,389
Bad Debt & Write-offs	588					587			1
Other Program Expenses	199,590	194,805							4,785
Total Program Cost	\$45,394,738	\$18,308,342	\$13,947,830	\$8,676,712	\$1,549,503	\$1,737,125	\$603,809	\$416,350	\$155,067
Less: Earned Revenues									
Interest, Federal (Note 12)	\$1,522,371	\$1,522,188				\$183			
Interest, Non-Federal (Note 12)	4,058,251	4,039,690				18,561			
Other Earned Revenue	6,153		\$17	\$4,110	\$1	1	\$25		\$1,999
Earned Revenues	\$5,586,775	\$5,561,878	\$17	\$4,110	\$1	\$18,745	\$25		\$1,999
Net Cost of Operations	\$39,807,963	\$12,746,464	\$13,947,813	\$8,672,602	\$1,549,502	\$1,718,380	\$603,784	\$416,350	\$153,068

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Consolidating Statement of Changes in Net Position
For the Year Ended September 30, 2001
(Dollars in Thousands)

Consolidated	Student Financial Assistance	Office of Elementary & Secondary Education	Office of Special Education & Rehabilitative Services	Office of Vocational & Adult Education	Office of Postsecondary Education	Office of Educational Research & Improvement	Office of Bilingual Education & Minority Languages	Department Management	
Net Cost of Operations	\$(39,807,963)	\$(12,746,464)	\$(13,947,813)	\$(8,672,602)	\$(1,549,502)	\$(1,718,380)	\$(603,784)	\$(416,350)	\$(153,068)
Financing Sources (Other than Exchange Revenues):									
Appropriations Used	\$40,730,970	\$13,466,364	\$13,926,219	\$8,608,448	\$1,527,097	\$1,695,388	\$559,198	\$409,518	\$538,738
Donations (Non-exchange Revenue)	535								535
Imputed Financing (Note 14)	20,600	129,421	59,960	64,175	20,451	41,684	54,402	7,055	(356,548)
Future Transfers Out due to Downward Subsidy Re-estimate	(2,707,275)	(2,706,125)				(1,150)			
Total Financing Sources	\$38,044,830	\$10,889,660	\$13,986,179	\$8,672,623	\$1,547,548	\$1,735,922	\$613,600	\$416,573	\$182,725
Net Results of Operations	\$(1,763,133)	\$(1,856,804)	\$38,366	\$21	\$(1,954)	\$17,542	\$9,816	\$223	\$29,657
Prior Period Adjustments (Note 15)	(152,829)	(48,343)	(98,942)	(2,095)	223	44,424	(13,031)	(220)	(34,845)
Net Change in Cumulative Results of Operations	\$(1,915,962)	\$(1,905,147)	\$(60,576)	\$(2,074)	\$(1,731)	\$61,966	\$(3,215)	\$3	\$(5,188)
Increase (Decrease) in Unexpended Appropriations	3,969,091	(514,217)	3,166,980	434,734	291,606	393,749	166,599	40,285	(10,645)
Change in Net Position	\$2,053,129	\$(2,419,364)	\$3,106,404	\$432,660	\$289,875	\$455,715	\$163,384	\$40,288	\$(15,833)
Net Position - Beginning of Period	26,598,756	9,043,533	8,291,475	4,902,279	1,220,296	1,882,709	623,144	506,996	128,324
Net Position - End of Period	\$28,651,885	\$6,624,169	\$11,397,879	\$5,334,939	\$1,510,171	\$2,338,424	\$786,528	\$547,284	\$112,491

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Combining Statement of Budgetary Resources
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Combined	Student Financial Assistance	Office of Elementary & Secondary Education	Office of Special Education & Rehabilitative Services	Office of Vocational & Adult Education	Office of Postsecondary Education	Office of Educational Research & Improvement	Office of Bilingual Education & Minority Languages	Department Management
Budgetary Resources									
Budget Authority	\$69,343,857	\$37,514,043	\$17,034,680	\$9,070,063	\$1,825,600	\$2,190,453	\$722,721	\$460,000	\$526,297
Unobligated Balance-Beginning of Period (Adjusted) (Note 16)	10,529,655	9,879,072	137,323	285,752	90,165	118,326	9,726	2,847	6,444
Spending Authority from Offsetting Collections (Adjusted)	27,638,727	27,505,541	61,504	8,928	71	55,145	5,035		2,503
Adjustments	(13,393,186)	(13,407,710)	161,001	(85)	1,042	(157,903)	2,793	302	7,374
Total Budgetary Resources (Note 17)	\$94,119,053	\$61,490,946	\$17,394,508	\$9,364,658	\$1,916,878	\$2,206,021	\$740,275	\$463,149	\$542,618
Status of Budgetary Resources									
Obligations Incurred (Adjusted) (Note 16)	\$86,385,110	\$54,749,795	\$16,664,824	\$9,222,249	\$1,849,891	\$2,174,136	\$734,382	\$458,117	\$531,716
Unobligated Balances-Available	2,213,757	1,293,179	703,861	117,241	66,087	28,848	965	2,213	1,363
Unobligated Balances-Not Available	5,520,186	5,447,972	25,823	25,168	900	3,037	4,928	2,819	9,539
Total Status of Budgetary Resources (Note 17)	\$94,119,053	\$61,490,946	\$17,394,508	\$9,364,658	\$1,916,878	\$2,206,021	\$740,275	\$463,149	\$542,618
Outlays									
Obligations Incurred (Adjusted) (Note 16)	\$86,385,110	\$54,749,795	\$16,664,824	\$9,222,249	\$1,849,891	\$2,174,136	\$734,382	\$458,117	\$531,716
Less: Spending Authority from Offsetting Collections (Adjusted)	(34,131,697)	(33,697,223)	(262,730)	(45,403)	(9,713)	(72,056)	(14,344)	(10,527)	(19,701)
Obligated Balance, Net-Beginning of Period (Adjusted) (Note 16)	36,112,102	17,466,300	8,809,370	5,120,416	1,272,691	1,995,726	725,207	557,393	164,999
Less: Obligated Balance, Net-End of Period (Adjusted)	(36,087,219)	(13,985,723)	(11,004,528)	(5,517,160)	(1,495,821)	(2,442,766)	(878,229)	(603,438)	(159,554)
Total Outlays (Note 17)	\$52,278,296	\$24,533,149	\$14,206,936	\$8,780,102	\$1,617,048	\$1,655,040	\$567,016	\$401,545	\$517,460

UNITED STATES DEPARTMENT OF EDUCATION
Departmentwide Combining Statement of Financing
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Combined	Student Financial Assistance	Office of Elementary & Secondary Education	Office of Special Education & Rehabilitative Services	Office of Vocational & Adult Education	Office of Postsecondary Education	Office of Educational Research & Improvement	Office of Bilingual Education & Minority Languages	Department Management
Obligations and Nonbudgetary Resources (Note 18)									
Obligations Incurred (Adjusted) (Note 16)	\$86,385,110	\$54,749,795	\$16,664,824	\$9,222,249	\$1,849,891	\$2,174,136	\$734,382	\$458,117	\$531,716
Spending Authority from Offsetting Collections and Adjustments (Adjusted)	(34,131,697)	(33,697,223)	(262,730)	(45,403)	(9,713)	(72,056)	(14,344)	(10,527)	(19,701)
Financing Imputed for Cost Subsidies (Note 14)	20,600	129,421	59,960	64,175	20,451	41,684	54,402	7,055	(356,548)
Financing Sources Transferred Out	(2,707,275)	(2,706,125)				(1,150)			
Exchange Revenue Not In the Entity's Budget	4,837,150	4,824,026				13,124			
Other	(17,221)					(17,221)			
Total Obligations and Nonbudgetary Resources	\$54,386,667	\$23,299,894	\$16,462,054	\$9,241,021	\$1,860,629	\$2,138,517	\$774,440	\$454,645	\$155,467
Resources That Do Not Fund Net Cost of Operations (Note 18)									
Change in Amount of Goods, Services, and Benefits Ordered But Not Yet Provided (Net Increases) Net Decreases	(\$1,009,541)	\$3,095,274	(\$2,570,631)	(\$576,673)	(\$312,522)	\$(444,007)	(\$170,933)	(\$38,330)	\$8,281
Credit Program Collections that Increase Liabilities for Loan Guarantees or Allowance for Subsidy	11,471,786	11,436,845				34,941			
Resources that Fund Expenses Recognized in Prior Periods	(41,431)	(4,311)	(1,886)	(3,970)	(860)	(4,297)	(4,120)	(500)	(21,487)
Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	(35,192,107)	(35,171,087)				(12,827)	(642)		(7,551)
Other Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	4,197,500	4,197,500							
Total Resources That Do Not Fund Net Cost of Operations	\$(20,573,793)	\$(16,445,779)	\$(2,572,517)	\$(580,643)	\$(313,382)	\$(426,190)	\$(175,695)	\$(38,830)	\$(20,757)
Costs That Do Not Require Resources (Note 18)									
Adjustments	\$75,145	\$11,503	\$56,525	\$7,951	\$1,298	\$1,674	\$557	\$47	\$(4,410)
Total Costs That Do Not Require Resources	\$75,145	\$11,503	\$56,525	\$7,951	\$1,298	\$1,674	\$557	\$47	\$(4,410)
Financing Sources Yet to be Provided (Note 18)	\$5,919,944	\$5,880,846	\$1,751	\$4,273	\$957	\$4,379	\$4,482	\$488	\$22,768
Net Cost of Operations (Note 19)	\$39,807,963	\$12,746,464	\$13,947,813	\$8,672,602	\$1,549,502	\$1,718,380	\$603,784	\$416,350	\$153,068

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidating Balance Sheet
As of September 30, 2001
(Dollars in Thousands)

Assets	Consolidated	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Intragovernmental Assets:				
Fund Balance with Treasury	\$17,196,330	\$7,757,905	\$785,901	\$8,652,524
Accounts Receivable, Net	4,488	4,488		
Interest Receivable				
Governmental Assets:				
Accounts Receivable, Net	111,469	107,136	4,333	
Credit Program Receivables, Net	80,315,862	5,586,788	74,729,074	
Advances	38,738	38,738		
Cash and Other Monetary Assets				
Property and Equipment	17,307	7,602	8,938	767
Other Governmental Assets	258,006	257,973		33
Guaranty Agency Federal & Restricted Funds Receivable	2,462,445	2,462,445		
Total Assets	\$100,404,645	\$16,223,075	\$75,528,246	\$8,653,324
Liabilities				
Intragovernmental Liabilities:				
Accounts Payable	\$3,410	\$1,189	\$2,045	\$176
Interest Payable				
Borrowing from Treasury	77,189,105		77,189,105	
Guaranty Agency Federal & Restricted Funds Due To Treasury	2,462,445	2,462,445		
Payable to Treasury	4,212,555	4,212,555		
Other Intragovernmental Liabilities	980	693	234	53
Governmental Liabilities:				
Accounts Payable	516,097	141,791	287,409	86,897
Accrued Grant Liability	899,180			899,180
Liabilities for Loan Guarantees	8,376,767	8,376,767		
Other Governmental Liabilities	119,937	67,565	47,779	4,593
Total Liabilities	\$93,780,476	\$15,263,005	\$77,526,572	\$990,899
Net Position				
Unexpended Appropriations	\$8,738,794	\$960,037	\$116,784	\$7,661,973
Cumulative Results of Operations	(2,114,625)	33	(2,115,110)	452
Total Net Position	\$6,624,169	\$960,070	(\$1,998,326)	\$7,662,425
Total Liabilities and Net Position	\$100,404,645	\$16,223,075	\$75,528,246	\$8,653,324

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidating Statement of Net Cost
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Consolidated	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Program Costs				
Intragovernmental				
Interest Expense, Federal	\$5,561,878	\$460,717	\$5,101,161	
Other Production Expense				
Contractual Service Expense	12,869	2,758	2,169	\$7,942
Salaries and Administrative Expense	95,518	36,655	36,040	22,823
Bad Debt & Write-offs				
Governmental				
Subsidy Expense	992,696	(314,305)	1,307,001	
Grant Expense	10,812,779			10,812,779
Interest Expense, Non-Federal	358	159	183	16
Contractual Service Expense	484,012	211,989	238,970	33,053
Salaries and Administrative Expense	153,427	58,086	33,803	61,538
Other Program Expenses	194,805	73,884	86,902	34,019
Total Program Cost	\$18,308,342	\$529,943	\$6,806,229	\$10,972,170
Less: Earned Revenues				
Interest, Federal	\$1,522,188	\$460,717	\$1,061,471	
Interest, Non-Federal	4,039,690		4,039,690	
Earned Revenues	\$5,561,878	\$460,717	\$5,101,161	
Net Cost of Operations	\$12,746,464	\$69,226	\$1,705,068	\$10,972,170

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidating Statement of Changes in Net Position
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Consolidated	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Net Cost of Operations	\$(12,746,464)	\$(69,226)	\$(1,705,068)	\$(10,972,170)
Financing Sources (Other than Exchange Revenues):				
Appropriations Used	\$13,466,364	\$2,779,600	(\$152,693)	\$10,839,457
Imputed Financing	129,421	2,682	1,361	125,378
Future Transfers Out due to Downward Subsidy Re-estimate	(2,706,125)	(2,706,125)		
Total Financing Sources	\$10,889,660	\$76,157	\$(151,332)	\$10,964,835
Net Results of Operations	\$(1,856,804)	\$6,931	\$(1,856,400)	\$(7,335)
Prior Period Adjustments	(48,343)	69	50	(48,462)
Net Change in Cumulative Results of Operations	\$(1,905,147)	\$7,000	\$(1,856,350)	\$(55,797)
Increase (Decrease) in Unexpended Appropriations	(514,217)	(385,856)	(7,388)	(120,973)
Change in Net Position	\$(2,419,364)	\$(378,856)	\$(1,863,738)	\$(176,770)
Net Position - Beginning of Period	9,043,533	1,338,926	(134,588)	7,839,195
Net Position - End of Period	\$6,624,169	\$960,070	(\$1,998,326)	\$7,662,425

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Combining Statement of Budgetary Resources
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Combined	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Budgetary Resources				
Budget Authority	\$37,514,043	\$3,454,474	\$23,351,458	\$10,708,111
Unobligated Balance-Beginning of Period (Adjusted)	9,879,072	8,180,062	4,991	1,694,019
Spending Authority from Offsetting Collections (Adjusted)	27,505,541	14,640,197	12,865,344	
Adjustments	(13,407,710)	(5,853,547)	(8,331,853)	777,690
Total Budgetary Resources	\$61,490,946	\$20,421,186	\$27,889,940	\$13,179,820
Status of Budgetary Resources				
Obligations Incurred (Adjusted)	\$54,749,795	\$15,174,803	\$27,879,824	\$11,695,168
Unobligated Balances-Available	1,293,179	4,711	261	1,288,207
Unobligated Balances-Not Available	5,447,972	5,241,672	9,855	196,445
Total Status of Budgetary Resources	\$61,490,946	\$20,421,186	\$27,889,940	\$13,179,820
Outlays				
Obligations Incurred (Adjusted)	\$54,749,795	\$15,174,803	\$27,879,824	\$11,695,168
Less: Spending Authority from Offsetting Collections (Adjusted)	(33,697,223)	(15,443,193)	(17,430,715)	(823,315)
Obligated Balance, Net-Beginning of Period (Adjusted)	17,466,300	3,708,214	7,231,442	6,526,644
Less: Obligated Balance, Net-End of Period (Adjusted)	(13,985,723)	(2,503,952)	(4,313,900)	(7,167,871)
Total Outlays	\$24,533,149	\$935,872	\$13,366,651	\$10,230,626

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Combining Statement of Financing
For the Year Ended September 30, 2001

(Dollars in Thousands)

	Combined	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Obligations and Nonbudgetary Resources				
Obligations Incurred (Adjusted)	\$54,749,795	\$15,174,803	\$27,879,824	\$11,695,168
Spending Authority from Offsetting Collections and Adjustments (Adjusted)	(33,697,223)	(15,443,193)	(17,430,715)	(823,315)
Financing Imputed for Cost Subsidies	129,421	2,682	1,361	125,378
Financing Sources Transferred Out	(2,706,125)	(2,706,125)		
Exchange Revenue Not In the Entity's Budget	4,824,026	1,738,457	3,085,569	
Other				
Total Obligations and Nonbudgetary Resources	\$23,299,894	\$(1,233,376)	\$13,536,039	\$10,997,231
Resources That Do Not Fund Net Cost of Operations				
Change in Amount of Goods, Services, and Benefits Ordered But Not Yet Provided (Net Increases) Net Decreases	\$3,095,274	\$650,570	\$2,477,101	\$(32,397)
Credit Program Collections that Increase Liabilities for Loan Guarantees or Allowance for Subsidy	11,436,845	4,462,601	6,974,244	
Resources that Fund Expenses Recognized in Prior Periods	(4,311)	(4,294)	(16)	(1)
Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	(35,171,087)	(10,932,311)	(24,237,862)	(914)
Other Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	4,197,500	3,109,009	1,088,491	
Total Resources That Do Not Fund Net Cost of Operations	\$(16,445,779)	\$(2,714,425)	\$(13,698,042)	\$(33,312)
Costs That Do Not Require Resources				
Adjustments	\$11,503	\$1,529	\$1,767	\$8,207
Total Costs That Do Not Require Resources	\$11,503	\$1,529	\$1,767	\$8,207
Financing Sources Yet to be Provided	\$5,880,846	\$4,015,498	\$1,865,304	\$44
Net Cost of Operations	\$12,746,464	\$69,226	\$1,705,068	\$10,972,170

ATTACHMENTS

Report of Independent Auditors

Report on Internal Control

Report on Compliance with Laws and
Regulations



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

February 27, 2002

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, 2001 and 2000, 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 which are not reportable but nevertheless warrant management's attention. These are being communicated in a separate letter for management's consideration.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the OIG are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us and Ernst & Young, LLP, during the audits.

Sincerely,

Lorraine Lewis

Enclosures



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

February 27, 2002

MEMORANDUM

TO: Jack Martin
Chief Financial Officer, Department of Education

James Lynch
Chief Financial Officer, Student Financial Assistance

FROM: Lorraine Lewis *Lorraine Lewis*

SUBJECT: FINAL AUDIT REPORTS
Financial Statement Audits
Fiscal Years 2001 and 2000
U.S. Department of Education
ED-OIG/A17-B0006

Attached are the subject final reports on the results of the audits of the Department's fiscal year 2001 and 2000 financial statements. 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.

You have been designated as the action officials responsible for the resolution of the findings and recommendations in these reports. The auditors have discussed the findings with you or appropriate members of your staffs at various times throughout the audits.

Please provide us with your combined final responses to each recommendation within 60 days of the date of this letter indicating what corrective actions you have taken or plan, and related milestones.

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

Jack Martin
James Lynch
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Please provide the Financial Improvement and Post Operation/Post Audit Group and the Office of Inspector General/Audit Services with quarterly reports on promised corrective actions until all such actions have been completed or continued follow-up is unnecessary.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the Office of Inspector General are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us and Ernst & Young, LLP, during the audits. Should you have any questions concerning the reports, please contact me or Thomas A. Carter at 205-5439 or 205-9327, respectively.

Attachments

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, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing for the fiscal years then ended. 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 identified certain aspects of the Department's financial reporting process as material weaknesses in internal control during fiscal years 2001 and 2000. The account analysis and reconciliation processes used by the Department have not been fully effective in compensating for these material weaknesses. As a result, during fiscal years 2001 and 2000, the Department has revised the opening balances in its previously issued financial statements for fiscal years 2000 and 1999, as described in more detail in Notes 15 and 16 to the financial statements. We were unable to obtain sufficient evidence or to otherwise satisfy ourselves as to the accuracy or completeness of these adjustments. In addition, the Department was unable to provide adequate documentation to support certain amounts reported in its consolidated balance sheets. Such amounts include approximately \$827 million and \$267 million in total assets, \$396 million and \$107 million in total liabilities and net position for fiscal years 2001 and 2000, respectively, that require further analysis and investigation to determine if such amounts have been recorded properly. The results of such analysis and investigation could result in the identification of additional adjustments to the financial statements.

In our opinion, except for the effects of such adjustments to the consolidated balance sheets, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing, 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 as of and for the years ended September 30, 2001 and 2000, the consolidated balance sheets and related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2001 and 2000, and its net cost, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the 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 Bulletins No. 97-01, as amended, and No. 01-09, as applicable, *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 February 4, 2002, 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

February 4, 2002
Washington, D.C.

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, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing for the years then ended, and have issued our report thereon dated February 4, 2002. That report noted certain matters that resulted in a qualification of our opinion on the consolidated balance sheets, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing.

Except for the matters discussed in the third paragraph of the Report of Independent Auditors, we conducted our audit 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 audit, 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.

Management is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that: assets are safeguarded against loss from unauthorized use or disposition; transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting principles generally accepted in the United States; and data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information. Because of inherent

limitations in any internal control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In 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.

We noted certain matters involving internal control and its operation that we consider to 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.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that 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.

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 and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. The remainder of this report details the reportable conditions, the first of which is considered a material weakness as defined above.

MATERIAL WEAKNESS**1. Financial Management Systems and Financial Reporting Need to Be Strengthened (Modified Repeat Condition)*****Background***

The Chief Financial Officers (CFO) Act and, in particular, OMB Bulletins No. 97-01, as amended, and No. 01-09, as applicable, *Form and Content of Agency Financial Statements*, require that financial statements be the culmination of a systematic accounting process. The statements are to result from an accounting system that is an integral part of a total financial management system containing sufficient structure, effective internal control, and reliable data. The Department relies on a variety of work-around procedures to prepare financial statements, including significant manual adjustments, due to deficiencies in the current general ledger system and the lack of a fully integrated financial management system.

Significant Progress Noted, but Additional Improvement Needed

Although this material weakness from prior years remains outstanding, the Department has made improvements to its financial reporting process and financial management activities during fiscal year 2001. For example, the Department:

- Formed the Management Improvement Team (MIT) at the direction of the Secretary of Education. The team was tasked to “develop a blueprint for management excellence at the Department”. The blueprint describes the Department’s commitment to management improvement and establishes a roadmap for these improvements and mechanisms for achieving accountability and performance throughout the Department.
- Began performing Grant Administration and Payment System (GAPS) subsidiary to Financial Management System Software (FMSS) general ledger reconciliations on a monthly basis. In performing these reconciliations, the Department was able to identify errors and discrepancies in a more timely manner than in prior years. Additionally, the monthly reconciliations enhanced their ability to research and resolve differences that reduced the possibility of numerous material differences existing at year-end.
- Began preparing monthly financial statements in May 2001, which helped the Department in identifying areas needing further study.
- Performed detailed analysis of certain general ledger account balances in an effort to correct unresolved differences that existed in prior years and correct

deficiencies in the postings of certain current year transactions to the existing general ledger system. Specifically, the Department performed procedures to align Direct Loan and Federal Family Education Loan (FFEL) subsidiary records and the FMSS general ledger, align budgetary sources and uses, and remove unmatched transactions from the undelivered orders and Fund Balance with Treasury account balances.

- Participated in studies of payment processes and enhanced segregation of duties in the Impact Aid program.

While progress has been made, 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. Specifically, FMSS is not used to produce a general ledger trial balance at the reporting group level or at a consolidated level, and certain transactions continue to be recorded in FMSS to incorrect general ledger accounts. Consistent with the prior years, the Department relies on manual adjustments to correct discrepancies and an automated tool to assist in consolidating and reporting financial results. The Department continues to compile the financial statements through a multi-step process using a combination of manual and automated procedures. These processes increase the risk that errors may occur in the Department's financial statements. To address the weaknesses identified with FMSS, the Department is implementing a replacement for the general ledger software package that management indicates began processing transactions in January 2002. Additionally, Student Financial Assistance (SFA), a performance-based organization within the Department, is in the process of developing and implementing a financial management system to support its financial reporting needs that will be integrated with the Department's general ledger. Management indicates the new SFA system began processing transactions in October 2001.

We noted that the Department did not identify the financial reporting process as a material weakness in its Federal Managers' Financial Integrity Act (FMFIA) report for fiscal year 2001; however, the financial management system was identified as an area with material nonconformance issues. In addition, reconciliations were also identified as a material weakness. We continue to believe that until a new financial management system is fully operational, working effectively, and appropriately supported, additional focus on financial reporting is needed. In addition, operational changes should be considered to further integrate the financial statement close process as part of the overall financial management system.

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

Report on Internal Control

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General Ledger

As a result of performing various account analysis and account reconciliations, consistent with the prior year, the Department recorded numerous restatements and reclassifications related to prior fiscal year financial statement balances. Within the Fund Balance with Treasury reconciliation, we noted that approximately \$258 million related to the FFEL program and \$206 million related to the Direct Loan program were reclassified to other governmental assets and accounts payable from Fund Balance with Treasury and cash and other monetary assets. Management is continuing to research the appropriate treatment of the related transactions. Additionally, the Department made a reclassification of approximately \$743 million that was included in the fiscal year 2000 Payable to Treasury balance to the Loan Guarantee liability in fiscal year 2001. The continuation of restatements and reclassifications of prior year results, as discussed in the credit reform section of the report, results from additional analysis performed by the Department but also reinforces concerns about the lack of an integrated financial management system and the Department's ability to report accurate and timely financial data.

Consistent with the prior year, the Department performed extensive analysis of certain general ledger account balances during fiscal year 2001 in an effort to resolve errors that existed in prior years. In addition, the Department experienced weaknesses during FY 2001 in the FMSS Document Type Standard Accounting Event (DOC SAE), which is a set of accounting code combinations used to facilitate correct posting. These weaknesses were also addressed through manual entries prepared by the Department. As a result of these procedures, the Department prepared a number of manual adjustments to correct balances reported in the general ledger. Adequate historical records were not always available, so in some cases adjustments were made based on the best available data and management's reasoned judgment as to the most likely cause of the discrepancies. While this adjustment process appears to have been pragmatic given the circumstances, the Department was unable to provide sufficient documentation to support these adjustments. For example, the Department restated prior year unobligated balances, obligated balances, and obligations incurred by (\$16) million, (\$227) million and \$229 million respectively. Additionally, the Department determined that various items of income and expenses recorded in fiscal year 2001 were actually incurred during the prior fiscal years. Therefore, prior period adjustments of approximately \$153 million were made to remove these items from current year income and expenses and reflect them in balances for net position. In many instances, the support for these adjustments consisted of journal voucher coding sheets. We also noted errors in certain manual adjustments that had been processed and approved by the Department. These errors resulted in additional manual adjustments being posted to the financial statements to correct errors made in other manual adjustments, calling into question the sufficiency of the adjustment preparation, review, and approval process. In addition, the use of manual adjustments increases the risk that errors and irregularities may occur.

During fiscal year 2001, we noted that unsupported differences remain in the subsidiary records and the general ledger records. For example, the Fund Balance with Treasury contains numerous unreconciled (unmatched) schedules between the general ledger (FMSS) and Treasury (6654) records. As explained earlier, the difference between the general ledger and Treasury records were reclassified as a \$258 million increase to other governmental assets and a \$206 million increase to accounts payable at year-end. The budget clearing account (91F3875) reflects a net debit balance of approximately \$145 million, while the suspense account (91F3885) reflects a net debit balance of approximately \$44 million as of year-end. At year-end, the accounts payable balance included certain disbursement-in-transit amounts that have not cleared the account since June 2001. In addition, approximately \$14 million of disbursements-in-transit were not confirmed by Treasury as of October 2001. Although the Department indicates that the activity in these accounts relate to reclassifications of amounts between appropriations and timing differences, the documentation provided to support these differences was not sufficient. Management has not yet determined the final resolution of these amounts.

Financial reporting is a key management control. OMB Circular A-123, *Management Accountability and Control*, 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." Given the system weaknesses identified above, the Department needs to strengthen its financial reporting in order to ensure full compliance with OMB Circular A-123.

Financial Statement Preparation

The Department prepared interim financial statements starting in May 2001 and prepared some interim financial information at earlier dates. However, these statements were not fully useful in presenting accurate and timely financial results. The draft financial statements as of June 30, 2001, which we understand due to time constraints were provided to us without having first been reviewed by management, contained financial statement line items that were not adequately reconciled or supported. The Department ultimately concluded that further work to refine the June 30, 2001 financial statements should not be performed in order to focus additional account analysis on subsequent months. Beginning in FY 2002, the Department will be required to submit interim financial statements as part of the requirements of OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. While lessons learned from preparing interim and year-end financial statements will be useful in strengthening the Department's process, there will be critical operational challenges that must be resolved in order to prepare accurate information on an interim basis in FY 2002.

The financial statements initially provided to us for the year ended September 30, 2001, had line items with balances different from that which would normally be anticipated. For example, initially, cash and other monetary assets on the balance sheet reported a balance of approximately \$288 million. These amounts were originally reclassified from Fund Balance with Treasury to cash and other monetary assets during FY 2001. However, the amounts did not represent cash and were subsequently reclassified. The majority of these amounts, approximately \$258 million, were reclassified to other governmental assets as an unexplained difference. Additional adjustments were made to the financial statements to correct line items that reflected balances different than anticipated, as discussed in the credit reform section of the report. We noted that the initial version of the financial statements contained mathematical errors in various notes to the financial statements, certain amounts that did not agree from the financial statements to their related notes, and certain FY 2000 amounts that did not agree to the audited prior year amounts. Based on further review and account analysis, management determined that certain account balances were not accurate. As a result of correcting entries identified, approximately 50 account balances in the primary financial statements changed between the first and second versions provided for audit.

OMB Circular A-123 states: "Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. The documentation for transactions, management controls, and other significant events must be clear and readily available for examination."

Additional Compensating Controls 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.

Because significant weaknesses exist in the Department's general ledger system, management must compensate for the weaknesses by implementing and strengthening additional controls to ensure that errors and irregularities are detected in a timely manner. Management has taken additional steps to compensate for system weaknesses, but further efforts are needed as discussed below.

Account Analysis and Reconciliations

The Department's procedures for account analysis and reconciliations are improving. We

noted improvements for fiscal year 2001, such as the analysis of general ledger account balances performed by the Department and performance of the GAPS to FMSS reconciliations noted earlier. However, we noted additional room for 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. Had the Department performed more effective periodic analysis of its general ledger accounts, these errors could have been identified and corrected by management. Additional issues with respect to reconciliations and account analysis related largely to FFEL activity are discussed in greater detail in the section of the report regarding credit reform. While it was noted that the Department did not identify financial reporting related to credit reform as a material weakness in its Financial Managers' Financial Integrity Act (FMFIA) report for fiscal year 2001, reconciliations were identified as a material weakness.

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 four known instances of duplicate or erroneous payments totaling approximately \$1.5 million made during fiscal year 2001. The funds have been accounted for in these instances and appropriately reflected in the financial statements. Management also identified additional immaterial instances of erroneous payments made in prior years that were recovered in 2001. The OIG also identified two potential duplicate payments totaling approximately \$500,000 that occurred in fiscal year 2001.

It is our understanding that the Department is cooperating in ongoing General Accounting Office (GAO) and OIG projects to identify improper payments and to review controls surrounding the disbursement process. That work has 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 reduced the number of employees with access to purchase cards, reduced certain purchase card spending limits, and eliminated the use of third party drafts during fiscal year 2001. 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.

Rigorous Review of Interim Financial Statements

During fiscal year 2001, the Department began producing financial statements on a monthly basis and faced many challenges in preparing such information. As noted earlier, many of the year-end and monthly financial statement balances contained errors

that required subsequent correction. The information provided by interim financial data should enhance management's ability to make informed decisions about corrective action steps that may be required to achieve desired financial and non-financial results. Building on the Department's emerging account analysis processes, accurate interim financial information can help identify areas meriting specific focus.

Recommendations:

We recommend that the Department of Education perform the following:

1. Complete the implementation plan for the replacement of the general ledger software package and ensure the transition occurs in a timely, controlled and documented manner. Also ensure that data from SFA's new financial management system is adequately integrated with the Department. In addition, the Department should ensure that the new general ledger software package will meet its financial reporting needs, including an automated closing process and interim reporting capabilities, thereby facilitating the preparation of financial statements by reporting group and at the consolidated level.
2. Assign reconciliation and analysis preparation and review responsibilities and define approaches to corroborate account balances for all significant accounts on a monthly or more frequent basis as appropriate.
3. Enhance policies and procedures surrounding the preparation and review of adjustments, ensure that adequate and sufficient supporting documentation accompanies each adjustment throughout the approval process, and provide training to ensure that individuals preparing and reviewing the adjustments receive sufficient guidance to meet financial reporting objectives.
4. Further implement data mining and other approaches as recommended by the MIT to search for duplicate payments and research improper payments that are identified and continue to refine internal controls in response to such efforts.
5. Resolve unreconciled differences specific to the disbursements-in-transit, budget clearing, and suspense accounts on a timely basis, and resolve the unreconciled variances currently reflected in other governmental assets and accounts payable.
6. Assess the roles and responsibilities of each Departmental office (including OCFO, SFA, and Budget Service) involved with the financial reporting process to ensure that appropriate resources and tools are available to achieve the financial reporting objectives established by management, particularly when competing duties such as staffing the MIT and implementing a new accounting system strain resources.

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."

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

- The Department prepared comparative financial statements for the first time during the fiscal year ended September 30, 2001, in accordance with the requirements of OMB Bulletin No. 01-09. As a result of this process, inconsistent and unexpected variations were noted in balances disclosed in financial statement note 4, "Credit Program Receivables and Liabilities for Loan Guarantees." For example, the "Components of Subsidy Transfers" indicated that fees to be collected for Direct Loans would result in an increase in the "Current Year Subsidy Transfers from Program Account." This is the opposite result that would be expected from the collection of fees. Upon further research, it was noted that the financial statement disclosures for "Components of Subsidy Transfers" merited additional review. Amounts disclosed for: (1) interest rate differential, (2) default, net of recoveries, (3) fees, and (4) other were initially incorrect in the prior year financial statements and the FY 2001 draft financial statements prepared by the Department. The total amount reported for "Current Year Subsidy Transfers" did not require revision. In addition, we also noted differences between the amount of FFEL loans receivable reported in the general ledger and amounts reported by guaranty agencies. While much of the difference may be appropriately accounted for in the allowance for loss, a net unexplained difference of approximately \$300 million remained. The Department attributed this difference to timing and definition differences, as well as potential data quality issues at the guaranty agencies. We also noted that while the Department's

reconciliations ensure that FFELP activity is posted into the general ledger, data in the general ledger is not adequately traced back to the subsidiary listings.

- During the analysis of the Allowance for Subsidy for Post-1991 FFEL loans, a negative (debit) balance was presented in the prior year and the current year draft financial statements. This would indicate that the Department was projecting to receive principal and interest in excess of the face amount of all such loan receivables. The Post-1991 FFEL loans have been in default for an extended period of time and have been returned to the Department under the reinsurance provisions of the FFEL loan program. Upon further review, it was determined that the calculation approach for the Allowance for Subsidy needed to be revised to account for the default subsidy rate inherent in the credit model calculation applicable to such loans. Based on this review, a \$3.6 billion reclassification adjustment was required to increase the Allowance for Subsidy (return the balance to a true credit) and reduce the Liabilities for Loan Guarantees in fiscal year 2000.
- During fiscal year 2001, the Department implemented the requirements of Statement of Federal Financial Accounting Standards (SFFAS) No. 18, "Amendments to Accounting Standards For Direct Loans and Loan Guarantees – SFFAS No. 2." SFFAS No. 18 requires that the disclosures for direct loans and loans guarantees be expanded significantly by adding the following requirements: (a) report subsidy re-estimates in two components: interest rate re-estimates and technical/default re-estimates, (b) display in a note to the financial statements a reconciliation between the beginning and ending balances of loan guarantee liability and the subsidy cost allowance for direct loans, and (c) provide disclosure and discussion for changes in program subsidy rates, subsidy expense, and subsidy re-estimates. As result of these requirements, the Department is required to aggregate the activity that flows through the Allowance for Subsidy for Direct Loans and Liability for Loan Guarantees for FFEL Loans into specific categories. During this process it became apparent that the Department should develop additional systems, policies and procedures to streamline the process for developing these disclosures and assuring the accuracy of the data disclosed. Further, we noted that monitoring of the information that flows through this account should be improved, with cash flows reconciled to guaranty agency and other subsidiary systems and validated through comparisons to subsidy model estimates, and any variances investigated.
- Budget Service is responsible for managing the Department's program budget, policy, and legislative development, which includes calculating the subsidy costs associated with the Department's loan programs. It is still unclear as to which organization within the Department (OCFO, SFA, and Budget Service) is monitoring the activity of the general ledger accounts, performing routine reconciliations of account activity to loan program systems or extracts, preparing supporting documentation for adjustments, or providing the explanations with regard to changes that occur from one

year to the next year in the loan liability estimate and in all FFEL-related budgetary and proprietary accounts. Without formalized written policies and procedures documenting each aspect of the estimation process, and without the use of quality assurance and validation checks for all aspects of the estimation process, the Department increases its risk that the estimation process may not be performed in a consistent manner, thereby increasing the likelihood for errors to occur. In light of interrelationships between activity reflected in the accounting and loan subsidiary records and amounts used in the development and recording of subsidy estimates, each of the above organizations must understand the subsidy estimation process, and the inputs to the Department's records, to ensure that the financial reporting and model estimating processes are appropriately executed in order to achieve management's objectives. Ultimately, the OCFO is responsible for the preparation of the financial statements for the Department, so it must have a clear understanding of how credit subsidy estimates are recorded, verified, accumulated, and disclosed. We note that in connection with the Secretary's "Blueprint for Management Excellence" action plan, a Department/OMB Student Loan Audit Modeling Working Group has been designated by the Department.

- The long-term cost for the FFEL loan program is reflected in the financial statements as 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. Additional detect controls and analytical tools should be used to evaluate the accuracy of the account balance. The current cash flow model has the capability to forecast the future liability for FFEL loans at a given point in time. This calculation can be used to benchmark if both the model and account balance are in approximate proper alignment for anticipated future costs. Significant differences noted would help indicate whether potential improper amounts were flowing through the liability account or the model was improperly forecasting future costs. Also, the model can project future guarantee costs by major activity. Analytical reviews of each activity component can be prepared to test the reasonableness of the total ending liability. Our audit process included a number of discussions with Budget Service that may form the initial underpinnings of such an approach.
- The Department does not have significant history of repayment data or historical trend analysis available to support the assumptions used 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, the number and dollar amount of consolidated loans has increased significantly in the last few years. 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.

As reflected in footnotes to the President's Budget for FY 2003, the Administration is in the process of developing revisions to the method of calculating cost estimates for the Department's guaranteed and direct loan programs. As late as January 2002, there were discussions regarding whether a revised process could be developed and potentially significant re-estimates reflected in the FY 2001 financial statements, and how OMB views regarding the Department's credit reform calculation were to be addressed, including issues related to appropriate interest rate assumptions and preparation of estimates for each type of loan by cohort year. These discussions drew to a close when the President's Budget was finalized in February 2002. As the Department seeks to comply with OMB directives to prepare and release audited financial statements earlier (November 2004 for FY 2004), the timing of conclusive consultations between OMB and the Department in future years should be addressed. A concerted approach drawing on FASAB, OMB budgetary and management personnel, and the audit community may be needed to address this issue, which in critical respects transcends Education Department issues. If these issues are not addressed, the risk increases that amounts reported in the financial statements may not be materially consistent with amounts reported in the President's Budget, and that sufficient procedures may not exist to timely address and account for potential re-estimates or methodology changes in the financial statements.

Recommendation:

We recommend that the Department of Education perform the following:

1. Perform detailed analysis and review of the activity that flows through the general ledger accounts specific to the loans and cash flows for subsidy costs and related allowance and loan liability estimates for the FFEL program. In addition, regular analytical reviews should be performed of all the critical elements of the affected accounts. Such analysis should be performed on a quarterly basis and should include a reconciliation between the general ledger credit reform accounts (e.g., 1399 or 2180) and the data submitted by the guaranty agencies and Department's subsidiary systems.
2. Enhance the current formal written policies and procedures to include documentation of roles and responsibilities of each organization, OCFO, SFA and Budget Service, involved with the financial reporting process of the subsidy costs and the related loan liability and allowance estimates.

3. Gather data in a manner that will enable the Department to better monitor and report on consolidations.
4. The long-term cost of direct loans is estimated based on FFEL cash flow activity. The Department should consider using direct loan cash activity for future projections of direct loan subsidy cost.
5. Emphasize in appropriate external communications regarding the subsidy estimates, including significant financial and budgetary reports and presentations, the sensitivity of the estimates to changes in assumptions.

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

In connection with the annual audit of the Department's fiscal year 2001 financial statements, we conducted a controls review of the information technology (IT) processes related to the significant accounting and financial reporting systems. These systems included: Education Central Automated Processing System (EDCAPS), National Student Loan Data System (NSLDS), Direct Loan Servicing System (DLSS), Federal Family Education Loan System (FFEL) and the Loan Origination Subsystem (LOS). 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 2001, the Department has made progress in strengthening controls over information technology processes. The implementation of new controls and the reinforcement of existing controls increased the effectiveness of internal controls in areas such as security management and disaster recovery planning. Among others, the Department has implemented logging and monitoring controls for the Windows NT platform that supports EDCAPS, strengthened the system software change management process, and implemented and tested a disaster recovery facility for EDCAPS. However, we find that continuous effort is needed to further address control weaknesses related to information technology and systems. In particular, audit reports prepared by the General Accounting Office (GAO) and the Office of Inspector General (OIG) identify control weaknesses that need to be addressed. These audit reports include:

- Department of Education's Implementation of GISRA, audit control number ED-OIG/A11-B0007 (issued by OIG);
- Disaster Recovery and Backup Plans for Selected Information Technology Systems, audit control number ED-OIG/A11-0009 (issued by OIG); and
- GAO Report: Education Information Security – Improvements Made but Controls Weaknesses Remain, audit control number GAO-01-1067 (issued by GAO).

With respect to overall security management, the Department needs 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, related to GAPS, the Department needs to strengthen controls over critical financial and sensitive grant information to prevent unauthorized access and disclosure. The Department has identified numerous security weaknesses, including the lack of an overall IT security program, in its Government Information Security Reform Act (GISRA) report and the "Agency-Wide Plans of Actions and Milestones". The Department also identified its IT Security Program as a material weakness in its FY 2001 Federal Managers' Financial Integrity Act report.

The material weakness previously discussed regarding financial management systems and financial reporting indicates that internal control within the Department is evolving and requires additional improvement. 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 audit reports issued by the GAO and the OIG.

4. Reporting and Monitoring of Property and Equipment Needs to Be Improved (Modified Repeat Condition)

We noted improvement in several items identified in the prior year reportable condition. For example, the Department continued implementing a capitalization policy for property and equipment, and also reviewed capitalized and non-capitalized expense object classes to determine that appropriate items were properly capitalized.

The Department hired an outside contractor to perform quality control testing of a sample of inventory items as of September 30, 2001. As of the date of this report, the final results of the outside contractor's work reconciling the results of the inventory observation and the Department's records maintained in subsidiary property systems were not available. While the Department is in the process of strengthening controls over the

monitoring and reporting of property and equipment, improvements are needed in the timeliness of its physical inventory and reconciliation procedures.

In addition, the Department's OIG has performed several reviews of controls over government-owned property in the hands of contractors, and noted that improvements are needed in several areas, including reconciliation procedures.

During FY 2001, we noted that information from the subsidiary inventory systems was not utilized to determine the amount of capitalized property and equipment to record in the financial statements. Instead, this information was obtained from the general ledger, since sufficient information, such as purchase price or purchase documentation, is not currently recorded in the subsidiary inventory systems. Without an efficient way to reconcile capitalized property and equipment amounts from subsidiary systems or other source documentation to the general ledger, the Department increases its risk that these assets may not be correctly stated in the financial statements.

Additionally, the Department does not have sufficient standardized policies and procedures in place for the receipt, tracking, and safeguarding of property and equipment, which potentially increases the risk that assets will not be appropriately accounted for or tracked. The lack of a central receiving location for all headquarters equipment also increases the difficulty of adequately accounting for assets. The Department has indicated that it is in the process of refining its current procedures in order to address these issues.

According to OMB Circular A-123, "Management controls must provide reasonable assurance that assets are safeguarded against waste, loss, unauthorized use, and misappropriation. Management controls developed for agency programs should be logical, applicable, reasonably complete, and effective and efficient in accomplishing management objectives." The timely performance and reconciliation of an annual physical inventory would strengthen the Department's adherence with the requirements of OMB Circular A-123.

Recommendations:

We recommend that the Department of Education perform the following:

1. Timely reconcile any discrepancies between the results of annual physical inventories of the Department's accountable property and internal records. Develop policies and procedures to adequately document the results of this process.
2. Develop and implement standard Department-wide policies and procedures for the receipt, tracking, and safeguarding of property and equipment to ensure that the Department maintains adequate accountability over assets.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the fiscal year 2000 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 2000 Material Weaknesses and Reportable Conditions

Issue Area	Summary Control Issues	FY 2001 Status
Financial Management Systems and Financial Reporting Need to Be Strengthened (Material Weakness)	Significant weaknesses in the Department's financial reporting processes existed as a result of the EDCAPS general ledger software package, Financial Management System Software (FMSS).	Improvements Noted – Modified Repeat Condition Material Weakness
Reconciliations Need to Be Improved (Material Weakness)	The Department did not perform proper or timely reconciliations of its financial accounting records.	Improvements Noted - Relevant conditions merged into related comments with Financial Reporting and Credit Reform
Controls Surrounding Information Systems Need Enhancement (Material Weakness)	Improvements are required in security over financial systems and in disaster recovery capabilities.	Improvements Noted – Modified Repeat Condition Reportable Condition
Improvement of Financial Reporting Related to Credit Reform (Reportable Condition)	Management controls need to be strengthened over financial reporting related to credit reform.	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.	Improvements Noted – Modified Repeat Condition Reportable Condition

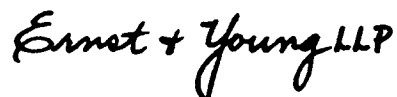
Report on Internal Control

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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 February 4, 2002.

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.



February 4, 2002
Washington, D.C.

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, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing for the fiscal years then ended, and have issued our report thereon dated February 4, 2002. That report noted certain matters that resulted in a qualification of our opinion on the consolidated balance sheets, and related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing.

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. We caution that noncompliance may occur and not be detected by the tests performed and that such testing may not be sufficient for other purposes.

The results of our tests of compliance disclosed no instances of noncompliance with other laws and regulations discussed in the previous paragraph exclusive of FFMIA 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.

Report on Compliance with Laws and Regulations

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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:

- The financial management system of record during FY 2001 impairs the Department's ability to accumulate, analyze, and present reliable financial information. This condition is primarily due to the absence of certain components of a fully integrated financial management system, and includes deficiencies in the general ledger system and manual adjustment process. The accounting system is in the process of being replaced. Certain other financial management controls, such as reconciliation processes, are continuing to evolve. In addition, the Department did not submit certain periodic financial reports on budget execution for the Direct Loan and Federal Family Education Loan Program (FFELP) financing accounts to Treasury as required due to reconciliation problems. We noted that the reports for the period ended September 30, 2001 were submitted.
- The Department has implemented and tested a disaster recovery facility for the Education Central Automated Processing System (EDCAPS). 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 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. In addition, the Department needs to strengthen controls in the Grant Administration and Payment System (GAPS) 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 2001 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 information related to the financial management systems and accounting standards that were found not to comply with the requirements of FFMLA. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMLA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management generally concurs with our findings and 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.

Report on Compliance with Laws and Regulations
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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

February 4, 2002
Washington, D.C.



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

FEB 25 2002

MEMORANDUM

To: Lorraine Lewis
Inspector General

From: Mark Carney *Mark Carney*
Deputy Chief Financial Officer

Subject: Draft Audit Reports
Fiscal Year 2001 Consolidated Financial Statement Audit
U.S. Department of Education
ED-OIG/A17B0006

We have reviewed the draft Fiscal Year 2001 Report of the Independent Auditors, Report on Internal Control, and the Report on Compliance with Laws and Regulations. We agree with the recommendations and conclusions contained in the report.

We are pleased that the report indicated that the U.S. Department of Education has continued to make significant progress in addressing long standing material and reportable conditions. Moving from three material weaknesses to one material weakness for Financial Management Systems and Financial Reporting was a major milestone. We will continue to address reportable conditions related to information technology, credit reform reporting, and property and equipment.

We are also pleased that your testing of compliance with laws and regulations disclosed no new instances of noncompliance with the laws and regulations required to be reported under Government Auditing Standards and Office of Management and Budget Bulletin Number 01-02. Our new accounting system, which was implemented January 22, 2002, is expected to correct 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 our appreciation to everyone on your staff who worked diligently on our financial statement audit. Please contact me at 401-3892 with questions or comments.

APPENDIX A
Glossary

Glossary

DLP	Direct Loan Program
ED	U.S. Department of Education
EDA	Electronic Debit Account
EDCAPS	Education Central Administrative Processing System
EFT	Electronic File Transfer
ESEA	Elementary and Secondary Education Act
FAFSA	Free Application for Federal Student Aid
FASAB	Federal Accounting Standard Advisory Board
FDLP	Federal Direct Loan Program
FFEL	Federal Family Education Loan
FFELP	Federal Family Education Loan Program
FMFIA	Federal Managers Financial Integrity Act
FMSS	Financial Management System Software
GA	Guaranty Agency
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
GAPS	Grant and Administrative Payment System
GED	General Education Degree
GMRA	Government Management Reform Act
GPRA	Government Performance and Results Act
HBCU	Historically Black College and University
HEA	Higher Education Act
HHS	Department of Health and Human Services
IASA	Improving America's Schools Act
IPOS	Institutional Participation and Oversight Service
IT	Information Technology
MIT	Management Improvement Team
NDNH	National Directory of New Hires
NAEP	National Assessment of Educational Progress
NLE	National Library of Education
OBEMLA	Office of Bilingual Education and Minority Languages Affairs
OESE	Office of Elementary and Secondary Education
OERI	Office of Educational Research and Improvement
OIG	Office of the Inspector General
OMB	Office of Management and Budget
OPE	Office of Postsecondary Education
OSEP	Office of Special Education Programs
OSERS	Office of Special Education and Rehabilitative Services
OVAE	Office of Vocational and Adult Education
PBO	Performance Based Organization
SFA	Student Financial Assistance

APPENDIX B
Department of Education
Web Sites

Department of Education Offices Web Sites:

U.S. Department of Education	http://www.ed.gov
Office of the General Counsel	http://www.ed.gov/offices/OGC/
Office of Inspector General	http://www.ed.gov/offices/OIG/
Office of Legislation and Congressional Affairs	http://www.ed.gov/offices/OLCA/
Budget Office	http://www.ed.gov/offices/OUS/budget.html
Office of the Under Secretary Planning and Evaluation Services	http://www.ed.gov/offices/OUS/PES/
Office of Management	http://www.ed.gov/offices/OM/
Office of the Chief Information Officer	http://www.ed.gov/offices/OCIO/
Office of the Chief Financial Officer	http://www.ed.gov/offices/OCFO/
Office of Student Financial Assistance Program	http://www.ed.gov/offices/OSFAP/
Direct Loans	http://www.ed.gov/offices/OSFAP/DirectLoan/
Direct Consolidation Loan Program	http://loanconsolidation.ed.gov
Free Application for Student Aid	http://www.fafsa.ed.gov
Office of Elementary and Secondary Education	http://www.ed.gov/offices/OESE/
Office of Educational Research and Improvement	http://www.ed.gov/offices/OERI/
Office of Vocational and Adult Education	http://www.ed.gov/offices/OVAE/
Office of Postsecondary Education	http://www.ed.gov/offices/OPE/
Office of Bilingual Education and Minority Languages Affairs	http://www.ed.gov/offices/OBEMLA/
Office of Special Education and Rehabilitative Services	http://www.ed.gov/offices/OSERS/
Office for Civil Rights	http://www.ed.gov/offices/OCR/
Office of Intergovernmental and Interagency Affairs	http://www.ed.gov/offices/OIIA/

