**Federal Student Aid**

**FY 2019 Statistically Valid and Rigorous Improper Payment Estimation Methodology**

**Introduction**

Federal Student Aid (FSA) management is committed to improper payment prevention, mitigation, and reduction. FSA continues to strengthen improper payment controls, and develop and enhance estimation methodologies, and analytics to monitor FSA programs. Accurate improper payment estimation is essential to achieving these objectives and will continue to inform root cause analysis and corrective actions, as described in part in the [Fiscal Year (FY) 2019 Agency Financial Report (AFR)](http://www2.ed.gov/about/reports/annual/index.html).

**FSA Programs Susceptible to Significant Improper Payment Risk**

In FY 2019, the Pell Grant (Pell) and Direct Loan (DL) programs are the only FSA programs identified as susceptible to significant improper payment risk. As required by statute, a risk assessment was performed on all FSA-managed programs, with the exception of the Pell and DL programs, in FY 2017. FSA has confirmed that there were no new FSA-managed programs and there were neither significant changes in legislation nor significant changes in funding requiring additional risk assessments be performed. As a result, this estimation methodology covers the Pell and DL programs only.

### Statistically Valid and Rigorous Estimation Methodology

In FY 2018, FSA identified an approach to overcome previously identified challenges with implementing a statistically valid estimation methodology for the Pell and DL programs. In FY 2019, FSA implemented a new statistically valid and rigorous estimation methodology. This new methodology improves the accuracy of the improper payment estimates. The methodology is based on a larger, random sample of schools.

FSA estimates the annual amount of improper payments for the Pell and DL programs by reviewing the results of annual compliance audits. Most schools that participate in an FSA program must have an independent auditor conduct an annual audit of the school’s compliance with the laws and regulations that are applicable to the Title IV programs in which the school participates (a compliance audit). Section 487(c) of the Higher Education Act of 1965 (HEA) requires each Title IV participating institution to submit to the Department a compliance audit and a financial audit “on at least an annual basis.” This statutory provision provides that the audit requirements can be met by submission of either an audit conducted under the *Guide for Audits of Proprietary Schools and For Compliance Attestation Engagements of Third-Party Servicers Administering Title IV Programs* issued by the Department’s Office of the Inspector General (OIG) (i.e., the “OIG Audit Guide”) or by submission of the results of an audit of the institution conducted under the Single Audit Act of 1984 (Single Audit Act), as amended in 1996. Compliance audits must be conducted in accordance with the standards contained in the [U.S. Government Accountability Office (GAO) Government Auditing Standards](http://www.gao.gov/yellowbook/overview). The type of compliance audit a school must undergo depends on what type of entity it is: for-profit, public, or nonprofit.

For-profit schools must have a compliance audit conducted under the OIG’s Audit Guide.[[1]](#footnote-2) Public and nonprofit schools must comply with the Single Audit Act. The Single Audit Act requires these schools to have an audit conducted in accordance with the Uniform Guidance, Subpart F, previously OMB Circular A-133, and Appendix XI, commonly known as the OMB Compliance Supplement. The Uniform Guidance allows a compliance audit under the criteria of the Audit Guideunder limited circumstances.

For both types of audits, the population of students who received Title IV program funds during the engagement period (fiscal year) is randomly sampled according to the guidelines set forth in the audit guidance. The selected samples are tested for reporting, student eligibility, disbursements, and, if appropriate, withdrawal calculations. Instances of noncompliance identified as part of the compliance audits are reported as findings[[2]](#footnote-3), even when corrective action has already been taken by the school.

A small population of public and nonprofit schools may apply for and receive an exemption from the compliance audit requirement. For-profit schools may likewise apply for a waiver from submitting a compliance audit or financial statements for a period of up to three years. Schools which receive waivers and exemptions comprise a very small fraction of the total disbursement amount across both programs. FSA accounts for these disbursements by including them in the statistically valid sampling.

**Pell Grant Program**

For both the Pell and DL improper payment estimates, FSA selects a statistically valid sample of schools. The most recently completed corresponding compliance audit for which the Student Financial Assistance (SFA) Cluster is a major program is selected in the sample and reviewed for improper payments.

The Pell estimate is based in part on all improper payments identified by the auditor for each sampled school. Additionally, the Pell estimate incorporates improper payment rates reported in the Free Application for Federal Student Aid (FAFSA) / Internal Revenue Service (IRS) Data Statistical Study (“Study”) to account for improper payments associated with misreported income. Improper payments identified in the compliance audits that relate to misreported income are excluded from the estimate as they should be accounted for by applying the Study rates to the sample disbursements. Also, to avoid double counting improper payments on one disbursement, the Study baseline overpayment error rate is not applied to those students whose entire Pell value was deemed improper through another procedure identified in the compliance audit. The improper payments for each sampled school are extrapolated to the population of Pell disbursing schools to produce a Pell improper payment estimate.

Based on this analysis, the Pell error rate for FY 2019 was **2.23** percent or **$646.14** million.

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| **FY 2019 Pell Grant Estimate****Two-Stage Estimator** |
| Point Estimate of Improper Payment (in millions) | Over-Payment Improper Payment Estimate(in millions) | Under-Payment Improper Payment Estimate(in millions) | Unknown Improper Payment Estimate(in millions) | Point Estimate (as % of Population Total) | Precision Rate (as a % of Population Total) based on 95% Confidence Interval |
| $646.14 | $380.04 | $211.18 | $54.92 | 2.23% | +/- 0.51% |

**Direct Loan Program**

The DL improper payment estimate includes three components:

* The DL compliance audit estimate, which is calculated in a similar manner as the Pell compliance audit estimate;
* An estimate derived from the sampling of loan consolidations; and,
* An estimate derived from the sampling of refund payments.

To estimate overall DL improper payments, these three independent statistical sample estimates are combined.

The loan consolidation component of the DL improper payment estimate is computed by sampling five overpayments and five underpayments from the universe of all underpayment and overpayment activities for each of the 12 months from July 2018 through June 2019 for a total sample size of 120. An independent sample of Federal Family Education Loan (FFEL) Program loan to DL consolidation overpayment and underpayment activity is selected using a Probability Proportional to Size (PPS) technique based on dollar amount to draw the sample to reduce the probability that small DL consolidations are selected. After selecting the monthly samples, each overpayment and underpayment is reviewed to determine which of these transactions are considered improper payments. Any improper payments found in the sample are extrapolated to create a 95 percent statistical confidence interval range of the overall improper payment rate for loan consolidation activity. The absolute value of improper payments divided by the aggregate absolute value of the samples comprises the baseline rate for DL consolidation.

The third component of the DL improper payment estimate is DL refund activity. A refund on a borrower’s account can occur when a payment is received for more than the amount due, resulting in a credit balance. In the case that the credit balance is less than $5, the account is closed out and written up to zero, unless the borrower requests a refund. A refund can also occur when a payment resides in an unapplied state in suspense and cannot be matched to a borrower’s account. An independent sample of DL refund activity is selected using a PPS technique to reduce the probability of selecting transactions that are deemed not material. The PPS sample of DL refunds is based on samples of 10 refunds for each month from July 2018 to June 2019 for a total of 120 sample items. Once monthly samples are selected, each refund is tested to determine if the samples are improper payments. The value of improper payments divided by the aggregate value of the samples comprises the baseline rate for DL refunds.

The DL compliance audit, consolidation, and refund rates are then applied to their representative

FY 2019 disbursements. The aggregate estimated improper payment amount for all three components is then applied to the total disbursement activity for the Direct Loan program to determine the overall Direct Loan improper payment rate of **0.52** percent or **$483.14** million.

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| **FY 2019 Direct Loan Estimate****Two-Stage Estimator** |
| Point Estimate of Improper Payment (in millions) | Over-Payment Improper Payment Estimate(in millions) | Under-Payment Improper Payment Estimate(in millions) | Unknown Improper Payment Estimate(in millions) | Point Estimate (as % of Population Total) | Precision Rate (as a % of Population Total) based on 95% Confidence Interval |
| $483.14 | $199.34 | $40.47 | $243.33 | 0.52% | +/- 0.56% |

1. https://www2.ed.gov/about/offices/list/oig/nonfed/schoolservicerauditguide.pdf [↑](#footnote-ref-2)
2. Per the OMB Compliance Supplement, auditors are not required to report findings within the audit reports for amounts below $25,000. As permitted by Uniform Guidance 2 CFR 200.517(b) and Title IV regulations at 34 CFR 668.23, this information was separately obtained from the auditors. [↑](#footnote-ref-3)