Review of Federal Student Aid's Monitoring of Financial Responsibility

FINAL INSPECTION REPORT

ED-OIG/I13K0001
March 2011

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U.S. Department of Education
Office of Inspector General
Washington, D.C.

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UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

Evaluation and Inspection

March 28, 2011

Memorandum

TO: William J. Taggart
Chief Operating Officer
Federal Student Aid

FROM: Wanda A. Scott /s/
Assistant Inspector General
Evaluation, Inspection, and Management Services

SUBJECT: Final Inspection Report
Review of Federal Student Aid's Monitoring of Financial Responsibility
(ED-OIG/I13K0001)

Attached is the **final inspection report** that covers the results of our Review of Federal Student Aid's Monitoring of Financial Responsibility. We received your comments on March 16, 2011. A copy of these comments in their entirety is attached.

In accordance with the Inspector General Act of 1978, as amended, the Office of Inspector General is required to report to Congress twice a year on the reports that remain unresolved after six months from the date of issuance.

In accordance with the Freedom of Information Act (5 U.S.C. § 552), reports issued by the Office of Inspector General are available 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 during this review. If you or your staff have any questions, please contact W. Christian Vierling, Director, Evaluation and Inspection Services at 202-245-6964.

Enclosure

Abbreviations/Acronyms Used in this Report

AAAD	Administrative Actions and Appeals Division
ARS	Audit Resolution Specialist
C.F.R.	Code of Federal Regulations
FAD	Final Audit Determination
FSA	Federal Student Aid
PEPS	Postsecondary Education Participants System

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EXECUTIVE SUMMARY

The objective of our inspection was to determine whether Federal Student Aid (FSA) takes appropriate action when it has identified that an institution is potentially not in compliance with the financial responsibility requirements. We found that FSA did not enforce the requirements for the timely submission of financial statement[1] and compliance audits; specifically,

1. FSA's current procedures do not define when an institution's failure to submit its annual financial statement and compliance audit would result in a determination that the institution is not financially responsible, and
2. Before implementing its current procedures, FSA did not enforce the financial responsibility requirement that institutions must submit letters of credit in order to continue participation after being cited for untimely audit submissions.

We recommend that the Chief Operating Officer for FSA –

1. Establish a reasonable timeframe in FSA's policies and procedures to address untimely financial statement and compliance audits according to 34 Code of Federal Regulations (C.F.R.) § 668.174(a)(3).

2. Cite institutions for late submission of audits and enforce the financial responsibility requirements that institutions must post letters of credit in order to continue participation when they have not submitted financial statement and compliance audits in a timely fashion.

We provided FSA with a copy of our draft report for comment. FSA did not disagree with our findings and concurred with our recommendations.

[1] When we use the term "financial statement" in this report, we are referring to audited financial statements.

BACKGROUND

According to 34 Code of Federal Regulations (C.F.R.) § 668.171(a), in order to "begin and to continue to participate in any [Title IV, Higher Education Act program (Title IV)], an institution must demonstrate . . . that it is financially responsible . . . ." Federal Student Aid (FSA) monitors institutions' compliance with the financial responsibility requirements. The regulations provide different types of protection for the Title IV programs when FSA determines that an institution is not meeting the financial responsibility requirements.

To determine whether an institution is financially responsible, institutions are required to annually submit financial information to the Department. An institution must provide this information in its financial statements as part of a combined submission that also includes the institution's compliance audit.[2]

Proprietary institutions have 6 months from the end of their fiscal year to submit their financial statements and compliance audits; public and private nonprofit institutions have 9 months.[3] If FSA determines that a submission is incomplete, it notifies the institution of corrective actions necessary for the submission to be deemed complete. FSA considers institutions to be late when they do not submit both the financial statement and compliance audit by the applicable 6-month or 9-month due date.

Institutions submit financial statements to the Department using the eZ-Audit system. After an institution submits its financial statement and compliance audit, FSA's Acceptability Review Team reviews the submission. The team screens financial statements for completeness and acceptability, sends letters to institutions when a submission is incomplete, calculates composite scores, and flags certain financial statements. The eZ-Audit system also automatically flags financial statements based on the data the institution enters. After the Acceptability Review Team's review, it forwards all flagged financial statements to the School Participation Team. The School Participation Team makes the final determination on an institution's financial responsibility using the procedures developed in 2006 to evaluate the institution.

A public institution is considered to be financially responsible if it is not in violation of any past performance requirement under 34 C.F.R. § 668.174. A proprietary or private nonprofit institution is financially responsible if the Department determines that the institution:

- Has a composite score of at least 1.5,
- Has sufficient cash reserves to make required returns of unearned Title IV funds,
- Is current in its debt payments, and
- Is meeting all of its financial obligations, including making required refunds, returns of Title IV funds, and repayments to cover FSA program debts and liabilities.

[2] For ease of reference in the text, we also use "audit" to refer to the combined submission of the financial statement and compliance audit.
[3] Public and private non-profit institutions can submit a single audit that includes the financial statement and required compliance information.

Institutions are not financially responsible if, in the last five years, they have been cited for failure to submit acceptable audit reports in a timely fashion (34 C.F.R. § 668.174(a)(3)).

The composite score combines elements from the financial statements to yield a single measure of an institution's overall financial health. The composite score can fall within three composite score scale zones:

- **1.5 to 3.0** The institution is financially responsible without further oversight.
- **1.0 to 1.4** The institution is "in the Zone." The institution is considered financially responsible but additional oversight is required.
- **-1.0 to .9** The institution is not financially responsible.

When the Department determines that an institution is not financially responsible, the institution must submit a letter of credit for at least 50 percent of its Title IV funding in order to continue participating in the Title IV programs. The institution may be permitted to participate under provisional certification with a letter of credit that has a smaller percentage amount, but the percentage may not be less than 10 percent.

FSA received 5,545 completed, annual or new institution submissions between October 1, 2007, and September 30, 2008. Of these, 1,873 were from public institutions (34 percent), 1,559 were from nonprofit institutions (28 percent), and 2,113 were from proprietary institutions (38 percent).

INSPECTION RESULTS

The objective of our inspection was to determine whether FSA takes appropriate action when it has identified that an institution is potentially not in compliance with the financial responsibility requirements. We found that FSA did not enforce the requirements for the timely submission of financial statement and compliance audits. In our review of FSA's analysis of 30 financial statements, we found that FSA did address instances where the composite score was failing or in the zone.

FINDING – FSA Did Not Enforce the Requirements for the Timely Submission of Financial Statement and Compliance Audits

We found that:

1. FSA's current procedures do not define when an institution's failure to submit its annual financial statement and compliance audit would result in a determination that the institution is not financially responsible, and
2. Before implementing its current procedures, FSA did not enforce the financial responsibility requirement that institutions must submit letters of credit in order to continue participation after being cited for untimely audit submissions.

Having current financial information helps the Department with its oversight responsibilities in protecting Federal funds. FSA's practice of not enforcing the requirements for timely audit submission provides no disincentive for failing to submit the audits on time.

According to 34 C.F.R. § 668.23(a)(4), proprietary institutions have 6 months from the end of their fiscal year to submit their financial statements and compliance audits, and public and private nonprofit institutions have 9 months.

The Secretary of Education has stressed the importance of the timely submission of financial statement and compliance audits. The preamble to the interim final rule for the 1994 financial responsibility regulations states that the Secretary believes the "reliability of any financial statement, as a fair representation of the institution's true financial condition, is largely dependent on the timeliness of the financial report." In the preamble to the final rule for the 1997 financial responsibility regulations, the Secretary states, "Under the regulations, an institution is required to submit audits within a fixed time period, and an institution's failure to do so is a serious matter."

The financial responsibility regulations specify the consequences for when institutions are cited for failure to submit financial statement and compliance audits in a timely fashion. According to 34 C.F.R. § 668.174(a)(3), an institution is not financially responsible if the institution "[h]as been cited during the preceding five years for failure to submit in a timely fashion acceptable compliance and financial statement audits required under this part, or acceptable audit reports required under the individual title IV, [Higher Education Act] program regulations."

1. FSA's current procedures do not define when an institution's failure to submit its annual financial statement and compliance audit would result in a determination that the institution is not financially responsible

FSA's current procedures, implemented in December 2006, state that an institution is formally "cited" only when an audit resolution specialist (ARS) issues a final audit determination (FAD) letter requiring the institution to repay all Title IV funds received for the audit period covered by the missing audit report. Since enacting its current procedures, FSA has not cited any institutions for late audit submissions under the financial responsibility regulations. FSA's procedures do not specify the amount of time after the due date that it will cite an institution for failing to submit required audits.

FSA has not established a deadline for noncompliance with the regulations that warrant a citation based on an institution's lack of timeliness. FSA's procedures address only when an institution's audit is missing, but do not address when an audit is submitted in an untimely fashion. Under the regulations, an institution is required to post a letter of credit for all 5 years following a citation for untimely submission.

Of the 5,475 completed, annual financial statements submitted within our review timeframe of October 1, 2007, to September 30, 2008, 2,400 (44 percent) were submitted past the regulatory deadline. Of the 2,400 late submissions, 798 (33 percent) were from public institutions, 628 (26 percent) were from private institutions, and 974 (41 percent) were from proprietary institutions. The chart below shows the number of submissions that remained missing over the course of the following year:

	Missing Audit Submissions	
Days Late	**Number**	**Percent**
15	1,540	28
30	887	16
180	137	3
365	86	2

FSA staff stated that they have not needed to cite institutions because they have worked with the institutions to obtain their late audits and that the institutions have been cooperative. FSA staff stated that their focus was to ensure receipt of the financial statement and compliance audits, and not to consider whether there was a financial responsibility problem related to late submissions.

Institutions participating in the Title IV programs are responsible under the regulations for submitting their financial statement and compliance audits on time, and FSA is responsible for enforcing the regulations. The Secretary has stated that an institution's failure to submit financial statement and compliance audits in a timely fashion is a "serious matter." The Secretary has further stated that "[t]o the extent that . . . an institution may inadvertently fail to submit an audit on time, that mistake is routinely corrected when the institution is contacted by the Department and asked to provide the missing audit immediately."

By definition, an audit is untimely if the institution does not submit it by the regulatory deadline. FSA staff stated that they consider institutions that do not submit a final, completed audit by the due date to be late; however, FSA's procedures do not call for a citation at that point.

FSA staff stated that the eZ-Audit system automatically sends two notifications to institutions that do not submit their audits by the deadline. The system sends the first notification immediately after the deadline passes and the second and final one 15 days later. FSA does not consider these notices to institutions to be citations for untimely submission of the financial statement and compliance audits. FSA staff stated that after 30 days the institution is placed on a missing audits list, at which point FSA staff will work with the institution to obtain the audit.

FSA's procedures state that if an audit is 6 or more months late, the ARS must include this fact as a finding in the enclosure to the FAD letter. In addition, the ARS will review the two prior audits to determine whether there is a pattern of late submissions. If either of the two prior audits is late, the ARS will issue a finding in the FAD letter for "Prior Audit Report Submitted Late," in addition to a finding for "Current Audit Report Submitted Late." Although the ARS must cite the institution for an untimely submission in the FAD letter, FSA does not consider this a citation for purposes of the financial responsibility regulations.

FSA has not followed its current procedures for issuing a late audit finding. FSA issued a finding of "Current Audit Report Submitted Late" for only 15 of the 137 institutions that were more than 180 days late. Although institutions had late prior audit submissions, none of the 137 institutions received a finding for "Prior Audit Report Submitted Late."

As noted above, the Secretary believes the reliability of any financial statement, as a fair representation of the institution's true financial condition, largely depends on the timeliness of the financial report. In those cases when a proprietary institution submits its financial statement and compliance audit more than 6 months after the submission deadline, the institution's next fiscal year has ended and the following fiscal year has begun. As a result, the financial statement and compliance audit is not a fair representation of the institution's true financial condition.

FSA's practice of not enforcing the requirements for timely audit submission and for posting of letters of credit does not provide a disincentive for failing to submit the audits on time. As noted above, during the timeframe for our review, 44 percent of institutions did not submit their audits by the regulatory deadline and 16 percent of audits were still outstanding 30 days after the deadline. FSA's lack of enforcement requires FSA to unnecessarily use human capital resources to follow up with the institutions that have not submitted their financial statements 30 days after the regulatory deadline. FSA's practice also places Federal funds at risk as it lacks timely, audited information on an institution's compliance with program requirements.

2. Before implementing its current procedures, FSA did not enforce the financial responsibility requirement that institutions submit letters of credit in order to continue participation after being cited for untimely audit submissions

FSA staff stated that before FSA implemented its current financial analysis procedures in December 2006, it cited institutions through actions taken by FSA's Administrative Actions and Appeals Division (AAAD). These actions included the revocation of a provisional program participation agreement, the denial of a recertification, an emergency action, or a termination action.

Between October 1, 2002, and November 30, 2006,[4] 3,314 institutions were at least 180 days late with their audit submissions. During this timeframe, AAAD took action on 13 institutions. Of these, seven institutions ceased participation in the Title IV programs after the action was taken. The remaining six institutions continued to participate in the Title IV programs but did not post a letter of credit for all 5 years following the citation as required by the regulations.[5] FSA's actions prior to its current procedures show a history of not enforcing the timely submission requirement.

Recommendations

We recommend that the Chief Operating Officer for FSA –

1. Establish a reasonable timeframe in FSA's policies and procedures to address untimely financial statement and compliance audits according to 34 C.F.R. § 668.174(a)(3).

2. Cite institutions for late submission of audits and enforce the financial responsibility requirements that institutions must post letters of credit in order to continue participation when they have not submitted financial statement and compliance audits in a timely fashion.

[4] We reviewed data for the five-year period prior to our October 1, 2007 - September 30, 2008 review timeframe.
[5] As specified in 34 C.F.R. § 668.174(a)(3), institutions are not financially responsible if they have been cited during the preceding five years for failure to submit timely financial statement and compliance audit reports.

DEPARTMENT COMMENTS

On February 11, 2011, we provided the Department with a copy of our draft inspection report for comment. We received the Department's comments to the report on March 16, 2011. FSA did not disagree with our findings and concurred with our recommendations. FSA stated that its monitoring of schools' financial responsibility has emphasized the receipt of schools' submission of financial statement and compliance audits rather than focusing on the requirement that the submissions be timely. FSA agreed that it has used considerable resources to follow up with institutions that have not submitted their financial statements timely. FSA stated that its financial analysis procedures have improved significantly in recent years, and that its analysis of late submissions shows that the number of overdue submissions between FY 2009 and FY 2010 for all types of schools was reduced by approximately 69 percent. We did not review the accuracy of FSA's analysis. The Department's response is attached in its entirety.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our inspection was to determine whether FSA takes appropriate action when it has identified that an institution is potentially not in compliance with the financial responsibility requirements.

We began our fieldwork on January 13, 2010, and conducted an exit conference on November 22, 2010.

We reviewed FSA's procedures, quality control and exception reports, and the eZ-Audit data dictionary. We also reviewed applicable regulations.

Review of FSA's process for reviewing financial statement audits. To determine FSA's process for reviewing financial statement audits, we reviewed FSA's Financial Analysis Procedures and Compliance Audit Procedures. We interviewed staff in FSA's Program Compliance office to evaluate FSA's implementation of its procedures. We also provided FSA with a flowchart of our understanding the process and provided FSA staff with the opportunity to revise our description.

Sample of FSA's review of financial statement audits. To answer our objective, we reviewed a random sample of FSA's analysis of flagged financial statement audits that were submitted between October 1, 2007, and September 30, 2008. For submissions in our sample, we reviewed FSA's Acceptability Review Team's and Case Management Team's analyses through the eZ-Audit system, the Postsecondary Education Participants System (PEPS), and the Electronic Records Management system.

To determine the population for our sample, we used data provided by FSA staff. We restricted the universe to include only completed, flagged annual submissions or new institution submissions that were archived by FSA. We further restricted the universe to include submissions that were flagged for at least one of the following reasons:

- Composite score of failed
- Composite score of zone
- Contingent liabilities disclosure in notes
- Department of Education compliance issue disclosure in notes
- Going concern disclosure in notes
- Going concern paragraph present
- Letter of credit on file
- Other than unqualified opinion
- Material weakness present
- Noncompliance present
- Prior year zone
- Reviews/investigations present
- Reportable conditions present
- Violation of debt agreement disclosure in notes

We excluded from the universe those submissions flagged for the following reasons that we determined did not directly relate to financial responsibility:

- 90/10 revenue attestation percentage > 89%
- Below threshold financial statements
- Change in auditor
- Change in ownership/merger submission
- New institution submission
- Reinstatement submission

FSA received 10,126 total submissions between October 1, 2007, and September 30, 2008. Of these, 5,545 were final, completed annual and new institution submissions. FSA flagged 1,161 of these submissions. The final universe of institutions that were flagged for at least one of the reasons listed above consisted of 974 institutions. There were 619 proprietary institutions (64 percent), 177 nonprofit institutions (18 percent), and 178 public institutions (18 percent). We used a stratified random sample of 30. We reviewed 20 proprietary institutions, 5 nonprofit institutions, and 5 public institutions. The number for each category of institution most closely reflected the percentage in the universe.

Review of late submission of audits. To determine the number of audits that were submitted past the institution's submission deadline, we reviewed the 5,475 final, completed annual submissions that fell within our timeframe of October 1, 2007, to September 30, 2008. We determined the number of days that elapsed by calculating the difference between the submission deadline and the date when the complete record was submitted to the eZ-Audit system. FSA staff reviewed our listing of institutions that were more than 180 days late and provided additional explanation for the late submissions, such as exemptions and extensions. We verified funding information using FSA's Current Integrated Partner Management Five Year Summary Funding Reports. Based on this analysis, we reduced the number of institutions that were more than 180 days late from 179 to 137.

Review of FSA's AAAD actions. We reviewed FSA's list of actions taken by AAAD. Of the 19 actions that took place between October 1, 2002, and June 28, 2010, 14 occurred before the current procedures were implemented in December 2006. We determined that these 14 actions were taken against 13 institutions. We reviewed FSA's analysis of these institutions through the eZ-Audit system and PEPS.

Our inspection was performed in accordance with the *Quality Standards for Inspections, 2005,* as appropriate to the scope of the inspection described above. These standards were adopted by the Council of the Inspectors General on Integrity and Efficiency in 2009.

CHIEF OPERATING OFFICER

MAR 16 2011

TO: Wanda A. Scott
Assistant Inspector General
Evaluation, Inspection, and Management Services
Office of Inspector General

FROM: William J. Taggart
Chief Operating Officer

SUBJECT: Response to Draft Inspection Report, *Review of Federal Student Aid's Monitoring of Financial Responsibility* (ED-OIG/I13K-0001)

Thank you for providing us with an opportunity to review and respond to the Office of Inspector General's draft inspection report, *Review of Federal Student Aid's Monitoring of Financial Responsibility*. The report states that Federal Student Aid (FSA) did not enforce the requirements for the timely submission of financial statement and compliance audits.

As your report notes, FSA's monitoring of schools' financial responsibility has emphasized the receipt of schools' submission of financial statement and compliance audits rather than focusing on the requirement that the submissions be timely.

FSA recognizes the importance of internal controls to program integrity and continually seeks to improve the effectiveness of our processes. Therefore, we were pleased to receive and we concur with your recommendation that we establish a reasonable timeframe in our policies and procedures to address untimely financial statement and compliance audits.

We also agree with your observation that FSA has used considerable resources to follow up with institutions that have not submitted their financial statements timely. FSA currently has various mechanisms in place to obtain and address late audit submissions. The eZ-Audit system sends automated notices when an audit is one day late, and a second notice at 16 days late. Program Compliance's case management teams are notified of missing audits via email monthly. When they receive the report of missing audits each month, they begin to work with any school that has not submitted its compliance audit and financial statement by the due date.

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FSA's financial analysis procedures have improved significantly in recent years. As a result, our analysis of late submissions shows that the number of overdue submissions between Fiscal Year (FY) 2009 and FY 2010 for all types of schools was reduced by approximately 69 percent. Nevertheless, we agree that we could ensure the receipt of timely financial statements and compliance audits further by enforcing the requirement that they be submitted timely.

Our specific response to each recommendation follows in the attachment. Again, we appreciate the opportunity to review and comment on the draft report.

Attachment

Attachment—Federal Student Aid's Response to Recommendations
Review of Federal Student Aid's Monitoring of Financial Responsibility
(I13-K0001)

Finding: FSA Did Not Enforce the Requirements for the Timely Submission of Financial Statement and Compliance Audits.

Recommendation 1.1: *Establish a reasonable timeframe in FSA's policies and procedures to address untimely financial statement and compliance audits according to 34 C.F.R. Section 668.17(a) (3).*

Federal Student Aid's Response: We agree with this recommendation. FSA will amend and clarify Financial Analysis and Compliance Audit Procedures to establish a reasonable timeframe to address untimely financial statement and compliance audits.

Recommendation 1.2: *Cite institutions for late submission of audits and enforce the financial responsibility requirements that institutions must post letters of credit in order to continue participation when they have not submitted financial statement and compliance audits in a timely fashion.*

Federal Student Aid's Response: We agree with this recommendation. FSA will amend and clarify Financial Analysis and Compliance Audit Procedures to cite institutions for late submission of audits and enforce the financial responsibility requirements.