UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

MAR 29 2002

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

Dear Mr. Secretary:

Attached are copies of the final management letters prepared by Ernst & Young, LLP, as a result of their examination of the fiscal years 2001 and 2000 financial statements for the Department and Student Financial Assistance. Copies are also being provided to the Office of the Chief Financial Officer, the Office of the Chief Information Officer, the Office of the Under Secretary, and Federal Student Aid.

The letters contain suggestions to assist management in improving procedures and controls within the Department. The results were discussed with Department officials throughout the audits. The Office of the Chief Financial Officer and Federal Student Aid commented on the findings and recommendations presented in the draft management letters and changes were incorporated as appropriate.

In accordance with the Freedom of Information Act (Public Law 90-23), products 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.

Sincerely,

Lorraine Lewis

Lorraine Lewis

Enclosures

ASSURANCE AND ADVISORY BUSINESS SERVICES

STUDENT FINANCIAL ASSISTANCE OF THE U. S. DEPARTMENT OF EDUCATION

Comments on Internal Control and Other Matters

Year ended September 30, 2001

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To the Inspector General
U.S. Department of Education

In planning and performing our audits of the consolidated balance sheets of the Student Financial Assistance (SFA), a performance-based organization of the U.S. Department of Education (the Department), in accordance with auditing standards generally accepted in the United States 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, we considered its internal control to determine our audit procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal control. We have separately reported in our Report on Internal Control dated February 4, 2002, certain matters involving internal control and its operation that we consider to be reportable conditions or material weaknesses under standards established by the American Institute of Certified Public Accountants.

The following suggestions, which resulted from our consideration of internal control, are submitted to assist management in improving procedures and controls.

I. Fund Balance with Treasury

Statement of Transactions Preparation Process (Repeat Condition)

The Department's Office of the Chief Financial Officer's (OCFO) procedures for reporting SFA's Fund Balance with Treasury (FBWT) activities to Treasury can be improved. During our testing of OCFO's procedures for preparing the Statement of Transactions (SF 224), we noted that the collection and disbursement transactions reported to Treasury via the SF 224 differed from transactions posted to the general ledger, the Financial Management System Software (FMSS). OCFO prepared the SF 224 by using the data provided in the Government On-Line Accounting Link System (GOALS) and Cash Link, instead of the data in its general ledger. Consequently, the collections activity recorded in the general ledger for the Direct Loan financing account, and the collections and disbursements activity recorded in subsidiary ledgers for the FFELP financing and liquidating accounts do not agree with the amounts reported in the Undisbursed Appropriation Ledger (FMS 6653). The activity in the general ledger and subsidiary ledgers exceeded the amounts reported in the FMS 6653 by $2.7 billion and $738 million for the direct loan financing account, and FFELP financing and liquidating accounts, respectively. While we were able to satisfy ourselves as to the Fund Balance with Treasury balance at year-end, the differences reflected OCFO's effort through manual adjusting entries to correct past errors and inadequacies in its Fund Balance with Treasury reconciliations. Also, the amounts reported on the Statement of Differences (FMS 6652) do not reflect true differences between balances in the general ledger and balances reported by Treasury in the FMS 6653.

A GAO report, *Reconciliation of Fund Balances* (GAO/AIMD-97-104R), established guidance for use by auditors in determining the adequacy of an agency's procedures to reconcile its FBWT. This guidance suggests that auditors determine whether agencies adequately prepare the SF 224 by using the same detailed accounting records of collection and disbursement transactions that are used to prepare the agencies' financial statements. The guidance also suggests that auditors determine whether agencies adequately research and resolve differences reported by Treasury on the Statement of Differences (SF 6652) and report adjustments to Treasury and post adjustments to accounting records in a timely manner (i.e. monthly).

We recommend that SFA coordinate with OCFO to perform the following:

- Modify the procedures used to record transactions in its accounting records for all Agency Location Codes (ALC's) so that the SF 224 preparers can effectively rely on the accounting data from the general ledger and accurately report transactions to Treasury.
- Perform reconciliations of its FBWT on a monthly basis for all major appropriations and quarterly for other appropriations.
- Thoroughly research differences and clearly document the resolution of the differences, including prior year differences.
- Post all correcting general ledger entries identified through the reconciliation process and communicate those entries promptly to Treasury via the SF 224.

SFA Response:

This was addressed in the Internal Control Report.

II. Direct Loans

GAPS to FMSS Loan Disbursement Reconciliations

The Grant Administration and Payment System (GAPS) processes requests for disbursing loan funds to schools. We tested a sample of the GAPS subsidiary to FMSS general ledger reconciliations for loan disbursements and noted that these reconciliations lacked documentation of supervisory review and approval. The lack of supervisory review and approval increases the risk that the reconciliations may contain errors or irregularities that may not be detected timely.

OMB Circular A-123, *Management Accountability and Control*, states that, "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."

We recommend that SFA coordinate with the Department to ensure that supervisory review and approval of all reconciliations is documented.

SFA Response:

SFA agrees that the reconciliation approval documentation can be improved.

Action to Be Taken:

- SFA management will maintain formal approval documentation.

III. FFELP Loans Receivable

Lack of Borrowers' Information

Lack of complete and accurate borrowers' information may impair SFA's ability to improve collections and effectively service defaulted loans assigned to SFA. Of the 32 confirmations sent to borrowers to confirm loan balances at year-end, five confirmations were returned as undeliverable. In addition, SFA was able to provide telephone numbers for only 19 borrowers. Four of the telephone numbers provided were either not in service or wrong numbers.

While we recognize that defaulted loans present unique challenges, we recommend that SFA continue to review its collection and file maintenance practices and determine if additional measures would aid in updating borrowers' records in the Debt Collection Service.

SFA Response:

SFA exhausts every possible resource in its collection practices and file maintenance. SFA/Collections receives address and telephone information from the entity (school, FFEL Guarantor, Direct Loan Servicer, etc.) assigning the student loan/grant to the Department. If this contact information is not provided or determined to be incorrect, there are several tools utilized to ascertain current data:

- Skip-trace account through a service provided by the Internal Revenue Service. DCS files are timely update from the skip-tracing results.

- Skip-trace activities are also routinely performed once an account is referred to Private Collection Agency (PCA) contractors. PCAs utilize various options available to them (i.e., Credit Bureaus, private locator contracts, etc.). The PCAs provide this data to Collections weekly, so that the Debt Management Collection System is updated in a timely manner.

- Match accounts against the National Directory of New Hires. This Directory provides home and employment contact information. DCS files are timely updated from the matching results.

- Request address update information from the U.S. Postal Service. DCS files are again timely updated.

In short, SFA/Collections spends considerable time, effort and resources to locate borrowers. Our collection efforts have long been used as the standard in Federal collection efforts.

IV. Monitoring

Monitoring of Guaranty Agency Reserve Funds (Modified Repeat Condition)

After analyzing the information reported on Form 2000, "Guaranty Agency Quarterly/Annual Report", we noted that guaranty agencies are only required to report balances for the Federal Fund and the Restricted Recall Fund as of September 30 each year. As a result, guaranty agency reserve balances can only be verified at year-end. Guaranty agencies (GA's) are required to submit other information, such as loans receivable, on a quarterly basis.

One of the uses of the Form 2000 is to track the financial condition of the guaranty agencies. This function will not be as effective if the reserve balances are only reported at year-end.

We recommend that SFA revise the Form 2000 to include the requirement that each guaranty agency report the Operating, Federal, and Restricted Recall Fund balance on a quarterly basis, which will allow the tracking of reserve balances throughout the fiscal year instead of only at year-end.

SFA Response:

SFA agrees with the intent of the recommendation.

Action to Be Taken:

- SFA plans to revise the Form 2000, "Guaranty Agency Quarterly/Annual Report" to include the requirement that each GA report only the balances of the Operating, Federal, and Restricted Recall Fund balance on a quarterly basis. This will allow SFA to track the reserve balance throughout the fiscal year instead of only at year-end. In addition, a review and revision of the methodology for the computation of the reserve on a quarterly basis is planned for the GA reserves.

V. Grant Disbursements

GAPS to FMSS Grant Expense Reconciliation

Grantees use the Grant Administration and Payment System (GAPS) to submit drawdown requests, via the Internet, to the Department. The transactions are accumulated and electronically transmitted to FMSS, the general ledger. Consequently, the grant expense from GAPS, the subsidiary ledger, should equal the grant expense from the general ledger. During our testing, we reviewed certain reconciliations of grant expenses between GAPS and FMSS for the period of October 1, 2000 through September 30, 2001. The reconciliations are used to show the difference between the grant expense on the financial statements and the grant expense per GAPS.

Management has taken significant steps forward during FY 2001 to begin to routinely reconcile the GAPS to FMSS grant expenses; however, additional improvements are needed. During our testing, we noted the following issues:

1. OCFO began preparing monthly reconciliations in April 2001. No monthly reconciliations were performed between October 2000 and March 2001; instead, the Department prepared a combined reconciliation for the entire six months.

2. Based on a review of the available documentation for FY 2001 reconciliations, we were unable to determine the timeliness of when the reconciliations were prepared or whether the reconciliations were reviewed and approved by a supervisor. Management has indicated that the reconciliations are approved via e-mail; however, no documentation was retained supporting the review and approval of the reconciliations.

3. We also obtained available FY 2002 documentation for the October 2001 and November 2001 GAPS-FMSS reconciliations and noted that these reconciliations were not complete as of January 2002.

Without timely reconciliations, the Department's risk of not detecting material errors or irregularities in the underlying financial data and financial statements is increased. In addition, the lack of evidence of supervisory review and approval increases the risk that reconciliations may not be finalized, potentially resulting in errors or irregularities that may not be detected timely.

We recommend that SFA coordinate with the Department to perform the following:

- Refine and enhance the existing procedures for the GAPS to FMSS grant expense reconciliation.
- Develop, document, and implement additional procedures to maintain records of reconciliations when completed, as well as evidence of supervisory review and approval.
- Reinforce the need to complete monthly reconciliations on a timely basis.

SFA Response:

SFA agrees that the reconciliation approval documentation can be improved, but we do not agree with the recommendations as stated.

The timeliness of reconciliations is a function of staff resource availability. There are times where consolidation of reconciliation periods is necessary to facilitate the process. All reconciliations are dated, reviewed and approved by management.

Action to Be Taken:

- SFA management will maintain formal approval documentation.

VI. Accrued Grant Liability

OCFO and Budget Service are responsible for preparing the accrued grant liability, which is also reported as part of SFA's financial statements. During our testing of accrued grant liability, we noted that some of the payees' reported liability exceeded their available balance as of

September 30, 2001. Management stated that for purposes of calculating the estimated liability the reported liability is capped at the available obligated balance amount when the confirmed liability amount exceeds the available balance per GAPS. The Department did not perform any follow up discussions or procedures for grantees that reported discrepancies, such as liabilities exceeding available balances.

Without procedures to follow up on discrepancies, the risk increases that the confirmations may contain errors or irregularities and not be detected timely, potentially resulting in grant liability information that is unreliable. In addition, although grantees have access to GAPS to monitor grant information, discrepancies may indicate that grantees are unaware of their available balances for grants.

The U.S. General Accounting Office's *Standards for Internal Control in the Federal Government* state 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.
We recommend that SFA work with the Department to develop and implement written policies and procedures for following up on discrepancies noted in confirmations submitted by grantees that are used to calculate the accrued grant liability. We also recommend that SFA coordinate with the Department to leverage its confirmation processes in this area to explicitly confirm grant awards, expenditures and/or advances to date, and available balances.

SFA Response:

SFA concurs with the overall intent of the recommendation.

SFA understands the auditor's concerns regarding the inherent limitations and imprecision in the current, sampling-based methodology for calculating the grant accrual, and agree that we should move toward a methodology based on internal program and financial data. Using historical data accumulated over the past few years, SFA is committed to developing an internal approach.

Action to Be Taken:

- SFA will review possible approaches to a grant accrual calculation based on internal data, evaluate the pros and cons of possible techniques. SFA in cooperation with the Office of Chief Financial Officer and Budget Service will develop and implement a revised methodology as appropriate.

VII. Accounts Payable

We noted that amounts recorded on the accounts payable aging schedule did not agree to accounts payable amounts recorded in the general ledger, FMSS, by approximately $28 million. Management was unable to provide adequate explanations as to the cause of the difference between the aging schedule and the general ledger or appropriately reconcile amounts between the two records.

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. Proper reconciliation of accounts shall consist of identification of differences between general ledger balances, subsidiary ledger, and the detail. The reconciliation must include the timely processing (preferably in the following month) of the identified items constituting the difference between controlling accounts and the detail. The documentation for transactions, management controls, and other significant events must be clear and readily available for examination."

We recommend that SFA coordinate with the Department to perform the following:

- Develop controls to ensure that the data entered into the aging schedule is correct in all aspects. In addition, provide additional training to staff responsible for the data entry processing and production of the aging report.
- Refine the review and monitoring procedures over the aging report to ensure that the data produced is correct and can be used for management's intended purpose.

SFA Response:

SFA concurs with the overall intent of the recommendation.

Action to Be Taken:

- SFA will evaluate the Oracle aging report as a part of the overall review of the standard accounts payable reports.
- Management will provide staff with the appropriate training and technical support.

VIII. Appropriations / Budget

SF-133's (Report on Budget Execution and Budgetary Resources)

SF-133's were not submitted to OMB for the first three quarters of the fiscal year for the FFELP financing appropriation (X4251) and the direct loan financing appropriation (X4253). In addition, we noted differences between the trial balance and the fourth quarter SF-133's for appropriations X4251 and X4253. For instance, at year-end for appropriation X4253, we noted a difference of $101 million for the Obligated Balance, Net – End of Period line item and a difference of $1.1 million, which was related to the Spending Authority from Offsetting Collections and the Obligated Balances – Not Available line items. In addition, at year-end for appropriation X4251, we noted a difference of $140 million for the Spending Authority from Offsetting Collections and the Unobligated Balances – Not Available line items and a difference of $47 million for the Obligated Balance, Net – End of Period.

OMB Circular A-34, *Instructions on Budget Execution*, states that the budget execution reports (SF-133) are to be submitted, "on a quarterly basis for all accounts, including those that OMB has exempted from apportionment." Additionally, OMB Circular A-123 requires that "documentation for transactions, management controls, and other significant events must be clear and readily available for examination."

We recommend that SFA perform the following:

- Develop/enhance its policies and procedures to ensure that SFA and OMB reporting requirements are met.
- Conduct supervisory reviews of data that is reported and ensure that adequate supporting documentation is maintained.

SFA Response:

SFA concurs with the recommendation concerning the timely reporting of the SF-133 report.

FY 2001 was a transition year for SFA for FACTS II. In FY 2000, SFA transmitted approximately 80-90 percent of its appropriations through FACTS II. In FY 2001, SFA by year-end transmitted 100 percent of its appropriations through FACTS II. For the first quarter of FY 2002, the SFA again transmitted 100% of its appropriations through FACTS II.

Action to Be Taken:

- None. SFA has achieved its goal of transmitting 100 percent of its appropriations through FACTS II.

Improvement in Analysis of Budgetary Account Balances

At September 30, 2000, the Direct Loan financing fund, X4253, had an obligated balance of $7.05 billion. In FY 2001, SFA de-obligated $4.6 billion based on revised estimated loan commitments. The significant change in estimated direct loan commitments may be an indication that account analysis is not adequate and needs further refinements.

Furthermore, during our testing of the Statement of Budgetary Resources, we noted material differences in the FFELP reporting group for the Obligations Incurred- Adjusted and Spending Authority from Offsetting Collections line items. Both of these line items are also reported on the Statement of Financing.

We noted that the 4902 general ledger account had a balance of $11.591 billion per the financial statements; however, per our analysis, $11.161 billion should have been recorded in that account. As a result, there is a difference of $430 million between the balance reported on the financial statements and our analysis of the balance. Furthermore, for the Spending Authority from Offsetting Collections line item, we compared the balance of $5.740 billion reported on the financial statements to the $5.002 billion per our analysis of the balance, which resulted in a difference of $738 million.

Failure to analyze key accounts and balances on a regular basis increases the possibility that errors or irregularities will not be detected timely.

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 periodic analysis of accounts and balances, periodic comparisons of actual balances to estimated balances, and timely resolutions of differences from expectations.

We recommend that SFA develop and enhance procedures for account analysis to ensure that periodic analyses are completed to detect errors and irregularities in a timely manner.

SFA Response:

SFA concurs with the overall intent of the recommendation.

While agreeing with the general focus of the recommendation, the specific concerns raised in the first issue seem to indicate a fundamental misunderstanding of the situation. There was no "overestimation" of direct loan commitments; all balances reflect legitimate commitments that were entirely appropriate at the time they were entered in SFA's financial systems. The adjustments reflect a policy change regarding when these legitimate commitments should be cancelled in the event that they are not disbursed.

Action to Be Taken:

- SFA is committed to continuing its thorough ongoing review of procedures to ensure that budgetary accounts are regularly reviewed, reconciled, and validated to ensure both internal accuracy and consistency with corresponding proprietary accounts.

President's Budget and Statement of Budgetary Resources (SBR) Differences

During our testing, we traced the balances per the audited SBR to the "actual" column reported in the FY 2003 President's Budget for each financial statement line item.

During our analysis of the SFA reporting group, we noted a difference of approximately $300 million for the Obligations Incurred line item and a difference of $882 million for the Spending Authority from Offsetting Collections line item.

Pursuant to OMB Circular A-34, agencies are to report budgetary information in the SBR based on the budget terminology, definitions, and guidance issued. It also states that the information on the SBR should be consistent with budget execution information reported in the President's Budget. Additionally, per Statement of Federal Financial Accounting Standard (SFFAS) No. 7, agencies are to provide financial statement note explanations of material differences between amounts presented in the SBR and amounts described as "actual" in the President's Budget.

We recommend that SFA perform an annual analysis, which will identify any differences between the information reported in the President's Budget and the information reported on the Statement of Budgetary Resources.

SFA Response:

SFA agrees with the recommendation.

Action to Be Taken:

- SFA will prepare this analysis for future audits.

IX. Net Position

Unobligated Balances

Excess funds for the FFELP liquidating account were not transferred to Treasury. At year-end, The FFELP liquidating account had a balance of $141,285,322 in Unobligated Balances – Unavailable and a balance of $4,471,643 in Unobligated Balances – Available.

OMB Circular A-11 states, "Amounts credited to liquidating accounts in any year are only available for obligations that are incurred in that year (the outlay may occur in a subsequent year) and for repayment of debt. In addition, any remaining unobligated balances at the end of the fiscal year are unavailable for obligation in subsequent fiscal years and must be transferred to the general fund at the end of the fiscal year unless OMB approves an extension."

We recommend that SFA record a Payable to Treasury to recognize these excess funds as unavailable for future obligations.

SFA Response:

SFA concurs with the facts and the recommendation.

Action to Be Taken:

- Recommendations will be accepted as stated.

Accrued Liabilities

SFA's management obligated funds for estimated FFELP costs incurred by guaranty agencies and lenders that have not been reported via Form 2000 and Form 799 reporting to SFA by year-end. The liability was not accrued.

Failure to record the accrual of a payable for these funds could affect the ability of the SFA's management and other users of the financial statements to assess the reasonableness and adequacy of the reserve available to meet future losses on outstanding guaranteed loans.

We recommend that SFA record an accrual of a payable for the estimated FFELP costs to recognize the portion of the estimated loan guarantee liability that is no longer available as a reserve for future losses on outstanding guaranteed loans. It may also be appropriate to accrue and report collection activity at guaranty agencies.

SFA Response:

SFA disagrees with the finding as presented.

SFA must record a budgetary obligation for Guaranty Agency disbursements to ensure that the Used Budget Authority for the reporting year is shown properly and the budgetary statements present a true statement of annual activity. SFA has done so for FY2001.

With respect to the accrued liability (accounts payable), SFA has consistently recorded its present value of future cash flows in the net loans receivable accounts (general ledger accounts 1350/1399) and loan guarantee liability (general ledger account 2180). The general ledger accounts 1399 and 2180 are cash driven and change only with the receipt or disbursement of cash.

If SFA were to record an accounts payable for Guarantee Agency disbursements, it would decrease the loan guarantee liability, thus shifting amounts from one liability to another. Because an actual cash flow has not taken place (the cash disbursements have not been made to the Guarantee Agency), the combined net loans receivable and loan guarantee liability would no longer represent the present value of future cash flows, as intended by Statement of Federal Financial Accounting Standard No. 2.

Action to Be Taken:

None.

X. Information Technology (IT) Issues (Repeat Condition)

As part of the audit of SFA's fiscal year 2001 financial statements, we conducted a general controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular A-130 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 resources 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 noting that manual procedures are generally not a viable back-up option. As a result of the procedures we performed, we noted several issues included as Appendix A to this report. Appendix A is for internal use only. It contains sensitive computer security-related information. Public disclosure of this information would risk circumvention of the law. Recipients of Appendix A must not, under any circumstances, show or release its contents for purposes other than official action. It must be safeguarded to prevent publication or improper disclosure of the information it contains.

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This report is intended solely for the information and use of the management of the Student Financial Assistance, the U.S. Department of Education and the Department's Office of the Inspector General, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

February 4, 2002