U.S. Department of Education's Compliance with the Improper Payments Elimination and Recovery Act of 2010 for Fiscal Year 2011

FINAL AUDIT REPORT

ED-OIG/A03M0001
March 15, 2012

Our mission is to promote the efficiency, effectiveness, and integrity of the Department's programs and operations.

U.S. Department of Education
Office of Inspector General
Philadelphia, Pennsylvania

NOTICE

Statements that managerial practices need improvements, as well as other conclusions and recommendations in this report, represent the opinions of the Office of Inspector General. Determinations of corrective action to be taken will be made by the appropriate Department of Education officials.

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March 15, 2012

TO: Thomas P. Skelly
Delegated the Authority to Perform the Functions and Duties of the Chief Financial Officer, Office of Chief Financial Officer
Lead Action Official

John W. Hurt, III
Chief Financial Officer, Federal Student Aid

FROM: Patrick J. Howard /s/
Assistant Inspector General for Audit

SUBJECT: Final Audit Report
U.S. Department of Education's Compliance with the Improper Payments Elimination and Recovery Act of 2010 for Fiscal Year 2011
Control Number ED-OIG/A03M0001

Attached is the subject final audit report that covers the results of our review of the Department's compliance with the Improper Payments Elimination and Recovery Act of 2010 for fiscal year 2011. An electronic copy of the report has been provided to your Audit Liaison Officers. We received your comments concurring with the findings and recommendations.

Corrective actions proposed (resolution phase) and implemented (closure phase) by your offices will be monitored and tracked through the Department's Audit Accountability and Resolution Tracking System (AARTS). The Department's policy requires that you develop a final corrective action plan (CAP) for our review in the automated system within 30 days of the issuance of this report. The CAP should set forth the specific action items, and targeted completion dates, necessary to implement final corrective actions on the findings and recommendations contained in this final audit report.

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 audits 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 have any questions, please contact me at 202-245-6949 or Bernard Tadley, Regional Inspector General for Audit at 215-656-6279.

Attachment

cc: James Runcie, Chief Operating Officer, FSA
Dawn Dawson, Audit Liaison Officer, FSA
Abigail Cornish, Audit Liaison Officer, OCFO
William Blot, Supervisory Systems Accountant, FSA
Phillip Juengst, Director of Internal Control, OCFO

Abbreviations, Acronyms, and Short Forms Used in this Report

AFR	Annual Financial Report
CFO	Chief Financial Officer
Department	U.S. Department of Education
Direct Loan	William D. Ford Federal Direct Loan
EFC	Expected Family Contribution
FAD	Final Audit Determination
FAFSA	Free Application for Federal Student Aid
FFEL	Federal Family Education Loan
FSA	Federal Student Aid
FY	Fiscal Year
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPIA	Improper Payments Information Act of 2002
IRS	Internal Revenue Service
OCFO	Office of the Chief Financial Officer
OIG	Office of Inspector General
OMB	Office of Management and Budget
Pell	Federal Pell Grant
Title I	Title I, Part A of the Elementary and Secondary Education Act of 1965, as amended
Title IV	Title IV of the Higher Education Act of 1965, as amended
SSA	U.S. Social Security Administration
SSN	Social Security Number

RESULTS IN BRIEF

The Improper Payments Elimination and Recovery Act of 2010 (IPERA) (Pub. L. No. 111-204)(2010), which amended the Improper Payments Information Act of 2002 (IPIA)(Pub. L. No. 107-300)(2002), and the Office of Management and Budget's (OMB) Circular A-123, Appendix C, Parts I and II, "Requirements for Effective Measurement and Remediation of Improper Payments" (OMB Circular A-123)(April 2011) require Federal agencies to reduce improper payments and report annually on their efforts. The IPERA and OMB Circular A-123, require each agency's Inspector General to review agency improper payment reporting in the Annual Financial Report (AFR), and accompanying materials, to determine whether the agency is in compliance with the IPERA.

What We Did and What We Found

Our audit focused on the U.S. Department of Education's (Department) improper payments activities for Title I, Part A of the Elementary and Secondary Education Act of 1965, as amended (Title I), the Federal Pell Grant (Pell), William D. Ford Federal Direct Loan (Direct Loan), and Federal Family Education Loan (FFEL) programs for the period October 1, 2010, through September 30, 2011, fiscal year (FY) 2011.

Objective 1. To determine whether the Department was in compliance with the IPERA.

For FY 2011, the Department complied with the IPERA.

Objective 2. To evaluate the accuracy and completeness of the Department's reporting.

The Department's reporting of its improper payment data was not always accurate and complete and limitations exist in the estimated improper payment rate methodology (that is, the methodology the Department uses to calculate the estimated improper payment rate) for the Title I, Pell, and Direct Loan programs. Specifically, we found improvements should be made to the estimated improper payment rate methodology for the Title I, Pell, and Direct Loan programs. We also found that the numbers, amounts, and percentages reported for the Pell and Direct Loan programs were not always based on accurate or complete data.

Objective 3. To evaluate the Department's performance in reducing and recapturing improper payments.

The Department is currently implementing its plans to reduce and recapture improper payments. The Department needs to continue its efforts for reducing and recapturing improper payments.

What We Recommend

The Department should consider revising the methodologies it uses to develop estimated improper payment rates to improve the accuracy and completeness of the data used in its calculations for the Title I, Pell, and Direct Loan programs. The Department should also obtain and review the supporting documentation for the Pell Program calculations from its contractors prior to issuance of the AFR, adequately describe in the AFR the methodology used for calculating the estimated improper payment rates for the Pell and Direct Loan programs in the AFR, and develop a corrective action plan to reduce improper payments that occur when FFEL Program loans are paid off by the Department to include them in Direct Consolidation Loans.

The Department should also update its analysis for determining whether payment recapture audits of all grant and loan programs would be cost-effective in FY 2012; revise and implement its payment recapture audit plans for all grant and loan programs based upon its updated analysis; and develop an estimated improper payment rate for the FFEL Program for FY 2012.

We provided draft findings and recommendations to the Department for comment. In its response, the Department concurred with the findings and recommendations. The Department's response is summarized at the end of each finding. The Department's written response is included as an Appendix to this report.

BACKGROUND

The IPERA, which amended the IPIA, and OMB Circular A-123, Appendix C, Parts I and II, "Requirements for Effective Measurement and Remediation of Improper Payments," require Federal agencies to reduce improper payments and report annually on their efforts. The OMB issued governmentwide guidance on the implementation of the IPERA on April 14, 2011, which is contained in OMB Circular A-123, Appendix C, Parts I and II.

The IPERA and OMB Circular A-123 require each agency's Inspector General to review the agency's improper payment reporting in its AFR, and accompanying materials, to determine whether the agency is in compliance with the IPERA.

Improper Payments

Under § 2(f)(2) of the IPIA, as amended by the IPERA, an "improper payment" is any payment that should not have been made or that was made in an incorrect amount. Incorrect amounts are overpayments or underpayments that are made to eligible recipients. An improper payment also includes any payment that was made to an ineligible recipient or for an ineligible good or service or payments for goods or services not received. In addition, according to OMB Circular A-123, Appendix C, Part I, a payment lacking sufficient documentation is an improper payment.

Significant Improper Payments

The IPERA and OMB Circular A-123, Appendix C, Parts I and II establish specific reporting requirements for agencies with programs that possess a significant risk of improper payments and for reporting on the results of improper payment recovery auditing activities. Agencies are required to review and assess, at least triennially, all programs and activities to identify those susceptible to significant improper payments. The guidance in OMB Circular A-123, Appendix C, Part I defines "significant improper payments" as those in any particular program that exceed (a) both 2.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported or (b) $100 million (regardless of the improper payment percentage of total program outlays). For each program identified as susceptible and determined to be at risk of significant improper payments, agencies are required to report an estimate of the annual amount of improper payments, along with steps taken and actions planned to reduce them.

COMPLIANCE WITH THE IPERA

Compliance with the IPERA

We found that the Department complied with the IPERA for each of the following compliance areas for the Title I, Pell, Direct Loan, and FFEL programs.

1. **Published an Annual Financial Report**
   Under § 3(a)(3)(A) of the IPERA, the Department was required to publish its AFR on its Web site. The AFR included an attachment, titled, "Improper Payments Reporting Details." Therefore, the Department complied with this requirement.

2. **Conducted a Risk Assessment**
   Under § 3(a)(3)(B) of the IPERA, a review must be performed for all programs to determine whether the program may be susceptible to significant improper payments.

   For FY 2011, the Department performed risk assessments for the Title I Program[1] and Federal Student Aid's (FSA) Title IV of the Higher Education Act of 1965, as amended (Title IV) programs. OMB waived the requirement that risk assessments be

[1] The Department stated that because the Title I Program was a former Section 57 program under OMB Circular A-11, "Preparation, Submission and Execution of the Budget," it was required to perform a risk assessment for the program. The Title I Program was listed on Exhibit 57B, "Programs for Which Erroneous Payment Information is Requested," of the former Section 57 of OMB Circular A-11. OMB Circular A-123, Appendix C, Parts I and II, does not include a requirement to report on former Section 57B programs. However, under OMB Circular A-136, "Financial Reporting Requirements," agencies are required to report on those programs previously identified in the former Section 57B of OMB Circular A-11. In the FY 2011 AFR, the Department reported that the Title I Program was not susceptible to significant improper payments.

performed for all non-FSA grant programs, other than Title I. Therefore, the Department complied with this requirement.

3. Published Improper Payment Estimates

Under § 3(a)(3)(C) of the IPERA, the Department was required to publish improper payment estimates for the Title I, Direct Loan, and Pell programs. The Department was not required to publish an improper payment estimate for the FFEL Program because it received a waiver from OMB for FY 2011.[2] Therefore, the Department complied with this requirement.

We reviewed the methodologies used to calculate improper payment estimates in the Title I, Pell, and Direct Loan programs. As discussed in Finding Nos. 1 through 3, improvements could be made to the methodologies used in calculating improper payment estimates in the Title I, Pell, and Direct Loan programs. In addition, as discussed in Finding No. 3, we found that the estimated improper payment rate for the Direct Loan Program included components that were not accurate or complete.

4. Published Report on Actions to Reduce Improper Payments (i.e., Corrective Action Plans)

Under § 3(a)(3)(D) of the IPERA, the Department was required to report its actions to reduce improper payments when a program was deemed susceptible to significant improper payments. For the Direct Loan and Pell programs, the Department reported its actions to reduce improper payments in the AFR. The Department received a waiver from OMB for the FFEL Program so it did not need to publish a corrective action plan for FY 2011. Because the Title I Program was not identified as susceptible to significant improper payments, this requirement did not apply to the program. Therefore, the Department complied with this requirement.

5. Published, and Has Met, Annual Reduction Targets

Under § 3(a)(3)(E) of the IPERA, the Department was required to report improper payment reduction targets when a program was identified as susceptible to significant improper payments. The Department published estimated improper payment rate reduction targets for both the Pell and Direct Loan programs, which it deemed to be risk susceptible. The FY 2011 estimated improper payment rates for the Pell and Direct Loan programs (2.72 percent and 0.22 percent, respectively) represent reductions from the FY 2010 rates (3.12 percent and 0.30 percent, respectively). Therefore the Department met its FY 2011 annual reduction targets. The Department did not need to report any targets for the FFEL Program because it had received a waiver from OMB for this requirement for the FFEL Program. Because the Title I Program was not identified as

[2] OMB granted FSA a waiver for the FFEL Program because prior efforts to calculate an estimated improper payment rate did not yield sufficient results.

susceptible to significant improper payments this requirement did not apply to the program. Therefore, the Department complied with this requirement.

6. **Reported Improper Payment Rate of Less Than 10 Percent**
Under § 3(a)(3)(F) of the IPERA, the Department was required to report estimated improper payment rates of less than 10 percent for each program identified as being at risk of significant improper payments. The Department reported FY 2011 estimated improper payment rates for the Direct Loan, Pell, and Title I programs at 0.22, 2.72, and 0.05 percent, respectively. These estimated rates were significantly below the 10 percent threshold. As discussed previously, the Department was not required to publish an estimated improper payment rate for the FFEL Program. Therefore, the Department complied with this requirement.

7. **Reported Efforts to Recapture Improper Payments**
Under Section 2(d) of the IPIA, as amended by the IPERA, and in accordance with OMB Circular A-123, the Department was required to report its efforts to recover improper payments identified in its recapture audits. On January 14, 2011, and November 1, 2011, the Department reported on its efforts to recapture improper payments. Therefore, the Department complied with this requirement.

As part of evaluating the Department's reporting on its efforts to recapture improper payments, we reviewed whether the Department performed payment recapture audits. According to OMB Circular A-123, Appendix C, Part I, an agency must report annually on its payment recapture audit program in its AFR. We determined that the Department did not develop a payment recapture audit program for the Direct Loan, Pell, FFEL[3] or Title I programs. Under § 2(h)(2) of the IPERA, for each program that expends $1 million or more annually, payment recapture audits should be performed if deemed cost-effective. The Department documented and notified OMB and the Office of Inspector General (OIG) that it determined that payment recapture audits would not be cost-effective. Therefore, the Department complied with this requirement. As discussed in Finding No. 4, the Department is currently implementing its plans to reduce and recapture improper payments. As such, the Department should update its analysis as to the cost-effectiveness of payment recapture audits in FY 2012.

[3] The Department received a waiver from OMB for the FFEL Program, so it was not required to publish an improper payment estimate.

FINDINGS AND RECOMMENDATIONS

Accuracy and Completeness of Reporting

We found weaknesses in the methodologies used to calculate the estimated improper payment rates for the Title I, Pell, and Direct Loan programs. We reviewed the Department's methodologies and supporting documentation to determine the accuracy and completeness of the numbers, amounts, and percentages reported in the "Improper Payments Reporting Details" contained in the FY 2011 AFR. Based on our review, we found that improvements should be made in the methodology used to calculate the estimated improper payment rates for the Title I, Pell, and Direct Loan programs; and that the numbers, amounts, and percentages contained in the "Improper Payments Reporting Details" for the Pell and Direct Loan programs were not always based on accurate or complete data.

FINDING NO. 1 - The Department's Calculation of the Estimated Improper Payment Rate for the Title I Program Was Not Complete

We found that the methodology used to calculate the estimated improper payment rate for the Title I Program should be improved to better capture expenditures reviewed in OIG audit reports and include data on improper payments available from other sources. The Department used A-133 Single Audits and OIG audit reports to calculate the estimated improper payment rate for the Title I program. For A-133 Single Audits, the estimated improper payment rate was calculated by dividing total questioned costs by the total expenditures contained in the reports.[4] However, for OIG audit reports, the estimated improper payment rate was not calculated based on actual expenditures reviewed by the OIG. Instead of obtaining the actual total expenditures reviewed by the OIG, the amount of questioned costs reported in OIG reports was also used as the total expenditure amount when calculating the estimated improper payment rate. For three OIG reports with questioned costs that were included in the calculation, the questioned costs of $82,113 were used as the total expenditure amount as well. The actual total expenditures reviewed for these three reports totaled $8.9 million. Although this treatment of OIG audit reports would have resulted in a minimal difference in the estimated improper payment rate the Department published, there could be significant differences in future years if questioned costs identified in OIG reports are substantially higher than the amount included in the calculation for FY 2011.

We also found that the Department did not include improper payment data from all available sources. The data available from OIG investigations and Department program offices, such as investigative and monitoring reports, were not included in the calculation of the estimated improper payment rate.

[4] A-133 Single Audits are audits performed by independent public accountants in accordance with guidance issued under OMB Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations."

RECOMMENDATION

We recommend that the Chief Financial Officer (CFO) for the Office of the Chief Financial Officer (OCFO)—

1.1 Consider revising the methodology used by the Department to calculate estimated improper payment rates for the Title I Program to include the results of OIG investigations, Department program reviews, and any other sources of reliable data.

Department Response

The Department concurred with our finding and its recommendation. The Department stated that its methodology could be improved by leveraging additional data sources to the extent possible and that it is exploring improvements to its estimated improper payment rate methodology for FY 2012.

FINDING NO. 2 - Issues Existed with the Availability and Completeness of the Calculation of the Estimated Improper Payment Rate for the Pell Program

Annually, FSA has a contractor conduct a statistical study (the "Free Application for Federal Student Aid (FAFSA)/Internal Revenue Service (IRS) Statistical Study") to calculate the estimated improper payment rate for the Pell Program. When applicants submit their FAFSAs to the Department, FSA verifies the applicants' identifying information by matching it with corresponding data maintained by the Social Security Administration (SSA). When the contractor conducting the FAFSA/IRS Statistical Study selects its sample of applicants, it excludes applicants whose social security number (SSN), name, and date of birth did not match the SSA data during FSA's match. Then the contractor matches the financial data for the sample's applicants and parents (if applicable) with corresponding data maintained by IRS, from the applicants' and parents' (if applicable) tax returns. We found that issues existed with the availability and completeness of this calculation.

Availability

<u>At the Time the AFR Was Published, FSA Did Not Have Complete Documentation Supporting the Estimated Improper Payment Rate</u>

The purpose of the FAFSA/IRS Statistical Study is to identify (1) income data that was misreported on the FAFSA (when compared to IRS data for the same year) and the potential misallocation of Pell awards; (2) the number of applicants for whom a mismatch between FAFSA and IRS data may be legitimate; (3) the types of applicants who are most likely to misreport income on the FAFSA; and (4) the validity of the edits used by FSA to select students for verification. The study also is used to determine the Pell Program's estimated improper payment rate reported in the AFR.

FSA officials did not obtain and review the contractor's deliverable (that is, the statistical study) used to support the estimated improper payment rate calculation before reporting it in the AFR. FSA officials solely relied on an email from the contractor as the support for the Pell estimated improper payment rate. The email included only the result of the estimated improper payment rate and did not include information about how that number was calculated. FSA relied on the email because the contractor was not required to provide the study until March 2012, approximately 4 months after the AFR was published on November 15, 2011. Relying on the email for the estimated improper payment rate would be reasonable provided that FSA officials knew that the methodology used by the contractor to develop the rate was the same as in the previous year.

In the FY 2011 AFR, the Department states that the methodology was the same and referred the reader to the previous years' AFR. However, when we reviewed the previous years' AFRs (FY 2009 and FY 2010), the methodology used to calculate the Pell estimated improper payment rate was not indicated. This calls into question whether FSA officials actually knew how the improper payment rate estimate was derived and whether it was accurate at the time the Department's AFR was published. FSA officials informed us that they understood the methodology because they engaged the contractor to perform the review. They also stated that the methodology was generally consistent with the methodology reported in the FY 2008 AFR and applied consistently from year to year.

Completeness

We determined that the study provided a methodology and generally described the steps the contractor took to compare FAFSA data to IRS data for FAFSA applicants. The most significant weakness of the process is that applicants, who may also be Pell recipients, who did not match either SSA or IRS data were excluded from the analysis. The study notes non-matching applicants as a limitation; no further analysis of the non-matching applicants was performed as a part of the study. Recipient data that does not match IRS data probably reflect a higher risk of improper payment than those whose names and SSNs matched SSA or IRS databases. By ignoring non-matches in the analysis, a potentially large source of improper payment was overlooked.

<u>SSA Non-Matches Were Not Analyzed</u>
As described earlier, before awarding aid to a student, FSA conducts a match with SSA to verify that the correct SSN was reported by the student and parent(s), if applicable. The FAFSA/IRS Statistical Study noted that the applicants whose SSN, name, and date of birth did not match SSA data in this match were excluded from the study. Because the study did not report this non-matching group size, or report on any characteristics of this group (such as the number of non-

matching applicants and recipients, if any), we did not have enough information to assess the effect that excluding this group would have on the estimated improper payment rate.

Impact of IRS Non-Matches on Improper Payment Rates
In the FAFSA/IRS Statistical Study it was stated that about 2.4 million or 15 percent of applicant records that matched SSA data did not match IRS data. The study matched applicants' data with IRS data based on the SSN of the student and parent(s), if applicable; the tax filing status (for example, not married/filing separately); and other factors. As discussed above, non-matching recipients might potentially be a source of higher improper payment risk. However, like the SSA non-matches, the contractor excluded these applicants, who may also be Pell recipients from the study. The Department did not attempt to assess the effect that excluding this group would have on the estimated improper payment rate.

Other Limitations of the Pell Program Estimated Improper Payment Rate
The study used by FSA to support the estimated improper payment rate for the Pell program does not include other factors that result in improper payments. For example, the following two factors were not considered when calculating the estimated improper payment rate:

- Recipients' eligibility for Pell grants, as determined under requirements in regulations; and
- Required recalculations of a Pell grant award when a recipient's enrollment status has changed.

According to FSA officials, FSA's planned FY 2012 estimated improper payment rate methodology will resolve some of the issues identified above by expanding the scope of the study to include Pell grant recipients that did not match either the IRS or SSA databases.

RECOMMENDATIONS

We recommend that the CFO for the OCFO, in conjunction with the CFO for FSA, require FSA to—

2.1 Ensure that a detailed report of the FAFSA/IRS Data Statistical Study, or other Pell estimated improper payment rate data, is received timely to allow the Department to evaluate and include in its AFR a description of the methodology that was used to calculate the rate;

2.2 Ensure that a description of the methodology used to calculate the estimated improper payment rate is included in the AFR; and

2.3 Revise the FY 2012 Pell Program estimated improper payment rate methodology to address the issues identified in this finding.

Department Response

The Department concurred with our finding and recommendations.[5] The Department stated that it plans to change its estimation methodologies for FY 2012 and that it will expand the description of the methodologies in future AFRs.

FINDING NO. 3 – The Department's Calculation of the Estimated Improper Payment Rate for the Direct Loan Program Included Components That Were Not Accurate or Complete

Accuracy

Use of Historic Rate Information May Not be Appropriate

In developing an estimated improper payment rate for the Direct Loan Program, FSA used data from fiscal years before FY 2011. FSA also assumed that the risk of improper payments remained static despite the large growth in the Direct Loan Program in recent years. The Health Care and Education Reconciliation Act of 2010 (Pub. L. No. 111-152)(2010) ended the origination of new FFEL Program loans after June 30, 2010, resulting in almost all new student loan volume being originated under the Direct Loan Program. In FY 2009, new loan volume in the Direct Loan Program was $28.9 billion, representing 30 percent of total new loan volume for the FFEL and Direct Loan programs. In FY 2011, new loan volume was $108.9 billion in the Direct Loan Program, representing almost all new loan volume. FSA conducted no research to support the assumption that the estimated improper payment rate would remain unchanged despite massive changes to the volume of the program and increase in the number of schools administering the program.[6] Guidance contained in OMB Circular A-123, Appendix C, Part I, states that risk factors which contribute to significant improper payments include, "Recent major changes in program funding, authorities, practices, or procedures . . . ."

Historic Rate Calculation May Have Been Flawed

To calculate the FY 2011 estimated improper payment rate, FSA calculated estimates of improper payment for seven different types of payments associated with the Direct Loan Program.[7] To estimate the amount of improper payments for Direct Loan disbursements,[8] FSA

[5] We revised our recommendations as follows: (a) removing draft recommendation 2.3, because the substance of the recommendation is included in recommendation 2.1, and (b) renumbering draft recommendation 2.4 as recommendation 2.3 in this final report.

[6] In FYs 2010 and 2011, about 677 new schools (415 were foreign schools) began administering the Direct Loan Program.

[7] The seven types of payments included in the estimate were: (1) Direct Loan Disbursements, (2) Drawdowns, (3) FFEL to Direct Loan Consolidations, (4) Direct Loan to Direct Loan Consolidations, (5) Direct Loan Servicing System Refunds to Borrowers and Others, (6) Title IV Additional Servicers Refunds to Borrowers and Others, and (7) Debt Collection Service Refunds for Borrowers/Rehab/Consolidation Loans.

officials divided (a) the total Direct Loan audit liabilities contained in Final Audit Determination (FAD) letters issued in FY 2010 for annual audits, performed by independent public accountants, of schools participating in the Title IV programs by (b) the total amount of Direct Loan funds disbursed in FY 2010. We found flaws in the calculation of the estimate of improper payments associated with the disbursement of Direct Loans. These flaws are described below.

- A FAD letter issued in FY 2010 could represent audit liabilities from years other than FY 2010 – the ultimate effect being an overstated numerator.

- If all disbursed funds were not covered by an audit, then using all funds disbursed in FY 2010 in the denominator understates the estimate. If prior fiscal year audit liabilities were used to generate the estimate, then the audit liabilities should have been divided only by the disbursements covered by the audits themselves to arrive at an estimated rate.

- Improper payments identified in FSA program reviews, OIG audits, and OIG investigations were not considered.

- Basing the estimate of improper payments on audit liabilities from FAD letters may result in an understated estimate. Under most circumstances, Direct Loan Program audit liabilities are based on an estimated loss formula. This formula results in an estimate of the loss to the Department associated with an ineligible loan. However, the improper payment amount for an ineligible loan consists of the total loan amount and associated payments, which would be larger than the audit liability calculated under the estimated loss formula.

Completeness

Estimation Methodology Not Adequately Described

The Department's methodology for calculating the Direct Loan Program estimated improper payment rate was not adequately described in the FY 2011 AFR. The FY 2011 AFR referred the reader to previous AFRs; however, the methodology was not adequately described in previous AFRs (FY 2009 and FY 2010) either.

Use of the Incomplete Sample Results

The estimated improper payment rate was based, in part, on sampling. However, there was no documentation regarding the sampling error for sample-derived estimates. For the results from the samples to be considered a valid statistical estimate, there needs to be an indication of what precision level they have.

[8] Loans are disbursed by eligible institutions certified to participate in the Direct Loan Program.

Estimates Were Calculated Using Incomplete Years' Worth of Data

The Department did not include all available data when calculating the estimated improper payment rate. For the Debt Collection Services Refunds for Borrowers/Rehabilitation/Consolidation Loans component, only a portion of the year's data (approximately 5½ months) was used to calculate the rate. Supporting documentation we obtained from FSA officials did not explain why only a portion of the year was used. The rate might have been different if the entire year's worth of data had been used instead.

For the estimate of the improper payments for FFEL to Direct Loan Consolidations, FSA did not have over- or underpayment data for the last month of the fiscal year (September 2011). Instead, this amount was estimated to be the average of the first 11 months of the year. We found that the overpayment rate changed throughout the year. The overpayment rate was the highest in the first quarter of the fiscal year then it decreased for the next two quarters. It is not clear if the lower overpayment rate in the second and third quarters of the fiscal year represent fewer actual overpayments or if the pattern results from a reporting lag between the time when the overpayment is made and when it is detected.

We found another weakness in the sampling of FFEL to Direct Loan Consolidation payments to calculate the improper payment frequency. The calculation was performed for part of the fiscal year (May 2011 through August 2011). However, a reporting lag may result in an understated amount. FSA officials reviewed transactions and a transaction error rate of 15.5 percent was determined. FSA officials based this error rate on the transaction counts and not the percentage of dollars that was overpaid.

Improper Payments From Expected Family Contribution Miscalculations Found in the FAFSA/IRS Statistical Study May Result in Improper Payments in the Direct Loan Program

The FAFSA/IRS statistical study shows that a percentage of recipients received the wrong Pell award based on an expected family contribution (EFC) derived from incorrect data on the FAFSA. If there were improper Pell awards based on EFCs derived from incorrect data, it is possible that recipients could also have inappropriately received subsidized loans. If so, the subsidized loan amount and related payments would constitute an improper payment. The estimated improper payment rate for the Direct Loan Program did not include improper payments resulting from incorrect EFCs.

The Department's AFR Does Not Address Corrective Action for FFEL to Direct Loan Consolidations Improper Payments

The improper payments figure that FSA reported for the FFEL to Direct Loan Consolidations component ($253,094,795) represents over 96 percent of the total Direct Loan Program's improper payment estimates. However, in the AFR, FSA did not describe its corrective actions to reduce these improper payments.

Accuracy and Completeness

When Sampling Was Used, Methodology Was Absent or Had Severe Deficiencies
As mentioned above, sampling was conducted for several components used to derive the Direct Loan Program estimated improper payment rate; however, there was no documentation explaining the criteria for evaluating what would constitute an improper payment, choice of sample size, the selection method or ultimate precision level of the results achieved. We found that:

- Two samples, each for a portion of the Direct Loan Servicing System Refunds to Borrowers and Others component, did not appear to be randomly selected. FSA drew two samples; however, neither sample appeared to be randomly selected because each sample's observations were for only 2 days.

- For the Title IV Additional Servicers Refunds to Borrowers and Others component, there was no explanation of how the sample sizes of 40 and 20 were appropriate. Because FSA did not create a written methodology, we could not determine whether the samples were random samples nor could we determine the precision level of the estimate derived from the sample.

- For the FFEL to Direct Loan Consolidations component, 16 overpayments and 16 underpayments were examined. There was no indication of the precision level attained by the sample.

RECOMMENDATIONS

We recommend that the CFO for the OCFO, in conjunction with the CFO for FSA, require FSA to—

3.1 Adequately describe the methodology in the AFR on how the Direct Loan Program's estimated improper payment rate was calculated;

3.2 Improve the loan disbursement portion of the Direct Loan improper payment rate calculation by matching the numerator (that is, audit liabilities) and denominator (that is, loan amounts disbursed) figures by award year;

3.3 Develop corrective actions to address FFEL to Direct Loan consolidation improper payments; and

3.4 Consider improper payments identified in OIG issued audit reports, FSA program reviews, and if applicable and available, OIG investigations in its Direct Loan estimated improper payment rate calculation.

Department Response

The Department concurred with our finding and recommendations. The Department stated that it is planning to implement new estimation methodologies for FY 2012 and that it will expand the description of the methodologies in future AFRs.

FINDING NO. 4 – The Department Needs to Continue Its Efforts in Reducing and Recapturing Improper Payments

The Department is currently implementing its plans to reduce and recapture improper payments; therefore, the OIG cannot adequately evaluate the Department's performance in this area. However, we found that the Department had made progress in implementing its plans as stipulated in its Payment Recapture Audit plan issued on January 14, 2011, and updated in November 2011.

Non-FSA Grant Programs

The Department does not plan to conduct payment recapture audits of grant programs because its analysis determined that it would not be cost-effective. However, as part of its plans to reduce and recapture improper payments for non-FSA grants, the Department plans to offer incentives for States to perform recapture audits. An official in the OCFO stated that the Department is having difficulties identifying incentives for States to perform recapture audits and plans to provide updates to OMB.

Although incentives have not been identified at this time, the Department has made some progress in implementing some of its other plans as stipulated in its Payment Recapture Audit Plan. For example:

- As part of the Department's preventive measures, it awarded a contract in September 2011, to acquire continuous monitoring software that will identify and prevent improper payments before they occur. According to Department officials, the continuous monitoring software is expected to be operational in spring 2012.

- The Department also awarded a contract in September 2011 to recommend (1) improvements in the Department's processes for estimating, tracking and reporting improper payments; (2) strategies for identifying and addressing root causes of improper payments; (3) enhancements to the methodology for calculating statistically valid improper payment rates and amounts; and (4) standard operating procedures for improper payment detection and incident reporting.

FSA Programs

In May 2011, FSA awarded a contract to assist it in meeting all of the IPERA requirements. The contractor is to assist FSA in areas such as: recommending and implementing strategies to reduce improper payment rates and amounts, assessing improper payment risk in the Title IV programs and activities, estimating improper payments, identifying high-dollar overpayments and supporting quarterly reporting on such overpayments, and establishing recovery audit programs where cost-effective. The contractor is to assist FSA in developing estimation methodologies for improper payments in the FFEL Program for FY 2012.

RECOMMENDATIONS

We recommend that the CFO for the OCFO require the Department to—

4.1 Update its analysis to determine whether payment recapture audits of all grant and loan programs would be cost-effective in FY 2012;

4.2 Revise and implement its payment recapture audit plans for all grant and loan programs based upon its updated analysis; and

4.3 Develop an estimated improper payment rate for the FFEL Program for FY 2012.

Department Response

The Department concurred with our finding and the recommendations. The Department stated that it will continue its efforts to reduce and recapture improper payments, update its cost-benefit analyses and plans for payment recapture audits, and develop and implement an estimated improper payment rate methodology for the FFEL Program for FY 2012.

OBJECTIVES, SCOPE AND METHODOLOGY

The objectives of our audit were to: (1) determine whether the Department was in compliance with the requirements of the IPERA; (2) evaluate the accuracy and completeness of the Department's reporting in the AFR; and (3) evaluate the Department's performance in reducing and recapturing improper payments.

Our review covered the Department's reporting and performance in reducing and recapturing improper payments for the FFEL, Direct Loan, Pell, and Title I programs. Our audit covered the period October 1, 2010, through September 30, 2011.

To accomplish our objectives, we performed the following steps.

1. Reviewed background information about the Department and the FFEL, Direct Loan, Pell, and Title I programs.

2. Reviewed the following laws, regulations, and guidance.
   a. IPERA (Pub. L. No. 111-204)(2010)

   b. IPIA (Pub. L. No. 107-300)(2002)

   c. OMB Circular A-123, Appendix C, Parts I and II, "Requirements for Effective Measurement and Remediation of Improper Payments," dated April 14, 2011

   d. OMB Memorandum M-11-04, dated November 16, 2010, "Increasing Efforts to Recapture Improper Payments by Intensifying and Expanding Payment Recapture Audits"

   e. OMB Circular A-123, Appendix C, Part III, "Requirements for Implementing Executive Order 13520: Reducing Improper Payments," dated March 22, 2010

   f. Executive Order 13520, dated November 20, 2009, "Reducing Improper Payments"

   g. SSA, OIG's guidance to the Council of Inspectors General on Integrity and Efficiency, titled, "OIG Responsibilities Under Improper Payments Elimination and Recovery Act," dated July 29, 2011

3. Reviewed the Department's AFRs for FYs 2009, 2010, and 2011, including the attachment, titled "Improper Payments Reporting Details."

4. Reviewed the AFR to determine the Department's compliance with the IPERA. Specifically, we reviewed the AFR to determine that the Department-

   a. Published an AFR for the most recent fiscal year;
   b. Conducted a program specific risk assessment, if required;
   c. Published improper payment estimates, if required;
   d. Published programmatic corrective action plans, if required;
   e. Published improper payments reduction targets;
   f. Reported an improper payment rate of less than 10 percent for each program for which an estimate was published; and
   g. Reported information on its efforts to recapture improper payments.

5. Interviewed officials from the Department's Office of Elementary and Secondary Education; officials from the Office of Planning, Evaluation, and Policy Development; and an official from the Office of the Under Secretary.

6. Interviewed officials from the Department's OCFO, officials from FSA's Business Operations office, and officials from FSA's Finance office.

7. Interviewed officials from the Department's contractors: Deloitte; Oak Ridge National Library; and ICF Macro, Inc., who assisted with the Department's activities to measure, remediate, reduce, and report on improper payments.

8. Reviewed the Department's methodologies for estimating improper payments and the related supporting documentation to assess whether the estimates were accurately calculated and based on complete data.

9. Reviewed the Department's payment recapture audit plan, dated January 14, 2011, and its updated payment recapture audit plan, dated November 14, 2011, to evaluate the Department's performance in reducing and recapturing improper payments.

Use of computer-processed data for the audit was limited to reports provided by the Department to support its improper payment estimations and methodologies. We used the data contained in these reports to determine the accuracy and completeness of the Department's improper payment estimation methodologies. We assessed the reliability of the Department's estimated improper payment rate data by (1) reviewing and analyzing some of the data and the data elements, (2) reviewing the methodologies and supporting documentation; and (3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for the objectives of this report.

We performed fieldwork at the Department's offices, located in Washington, D.C., from November 2011 through March 2012. We discussed the results of our audit with Department officials on March 5, 2012.

We conducted this compliance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

TO: Patrick Howard
Assistant Inspector General for Audit
Office of Inspector General

FROM: Thomas P. Skelly /s/
Delegated to Perform Functions and Duties
of the Chief Financial Officer

John Hurt /s/
Chief Financial Officer for
Federal Student Aid

SUBJECT: "Audit of the U.S. Department of Education's (ED) Compliance with the Improper Payments Elimination and Recovery Act of 2010 (PL 111-204, enacted July 2010) (IPERA)," Control Number ED-OIG/A03-M0001

Thank you for providing us with an opportunity to respond to the Office of Inspector General's (OIG) draft report.

We are pleased that your audit found the Department in compliance with the requirements of IPERA. The Department is committed to reducing and preventing improper payments. Since the enactment of IPERA, the Department has intensified efforts to identify and eliminate errors as well as potential for fraud, waste, and abuse. We have implemented a strong program to reduce the estimated rate of improper payments, especially in our Federal Student Aid programs, and we look forward to further strengthening our efforts through your review and recommendations.

As noted in your draft report, the Department has taken many actions to comply with IPERA. We have established processes for assessing the risk of improper payments, estimating the rate of improper payments in susceptible programs, identifying and reporting overpayments, and conducting recapture audits for contracts. In addition, we are in the process of assessing and strengthening these efforts by developing more rigorous approaches to our risk assessments and estimates, identifying root causes and implementing corrective actions to reduce improper payments, and implementing new approaches and technologies to identify and prevent improper payments before they occur.

We appreciate the way in which you have collaborated with the Department in conducting this review, providing multiple opportunities for input and refining your report based on this input. Our response to each of the findings in the draft report follows:

Finding 1: The Department's Title I Program Improper Payment Rate Estimation Calculation Was Not Complete.

Response to Finding 1: We concur with Finding 1 that our estimation methodology for Title I can be improved. Our current methodology has not included all OIG investigations or other potential data sources because the methodology was originally developed to rely on questioned costs from the most recent audit data—usually the prior year. Our methodology also relies on certain key assumptions in an effort to balance factors that are difficult to estimate in a statistically representative way. For example, it assumes all questioned costs are improper payments even though we have historical data that show some questioned costs are not sustained during the audit resolution process. The methodology also assumes a 100 percent improper payment rate for any OIG questioned costs included in the estimate. Both of these assumptions may overstate improper payments. Including all the expenditures reviewed by OIG audits would reduce the overall improper payment rate. Including only the expenditures reviewed by OIG audits with questioned costs would reduce the rate even further. However, we acknowledged in the AFR that these assumptions are balanced, to some extent, by the reality that OIG audits generally review only a small sample of grantee expenditures, meaning actual improper payments may be higher. Despite these data limitations, we concur that our methodology could be improved by leveraging additional data sources to the extent possible.

Recommendation:

1.1 Consider revising the methodology used by the Department to estimate improper payments to include the results of OIG investigations and Department program reviews.

Response to Recommendation 1: As stated at the start of this audit, we are committed to reviewing and strengthening our approach to improper payment risk assessment. Therefore, we certainly concur with recommendation 1.1 to consider strengthening our estimation of improper payments for Title I. We are currently exploring improvements to our estimation methodology for FY 2012 and will work to better incorporate all OIG audits and investigations. In addition, we will explore the possibility of leveraging program office data to the extent it is available and feasible. We would appreciate any suggestions the OIG may have for incorporating data from these sources into our methodology in a way that will improve its statistical validity.

Finding 2: Issues Existed with the Availability, Accuracy, and Completeness of the Pell Program Improper Payment Rate Estimation Calculation.

Response to Finding 2: We concur with Finding 2 that our estimation methodology for Pell can be improved. As noted in the AFR, management previously found that the inaccuracy of self-reported financial data on the FAFSA is the most significant root cause of potential improper payments. For FY2011 (and prior year) improper payment reporting, we employed a risk-based approach prioritizing this root cause. We compared this self-reported recipient data to an authentication source (i.e., IRS tax data) using the study to measure potential error and conduct analyses with an intent to reduce this error. As noted in the report, we are working to revise our FY2012 estimation methodology to broaden the scope of our analysis beyond this primary root cause.

We also concur that we can improve our AFR reporting to better describe our estimation methodologies. The report questions management's understanding of the FY2011 Pell methodology, in part, because of the lack of a detailed description of that methodology in the current or prior year AFRs. (The study was last described in detail in the FY2008 AFR.) To ensure the reader has a full understanding of the methodology used and the precision of the estimate, we will expand on the description of the new methodology in the FY2012 AFR, including changes from the prior year.

Recommendations:

2.1 Obtain a copy of the FAFSA / IRS Data Statistical Study or other Pell improper payment rate estimation deliverable prior to issuance of the AFR and determine whether the methodology used to calculate the percentage is present and is based on accurate and complete data;

2.2 Ensure that the methodology used to calculate the improper payment rate estimation is included in the following year's AFR;

2.3 Consider moving the due date for future deliverables of the FAFSA / IRS Data Statistical Study or other Pell improper payment rate estimation deliverable prior to issuance of the AFR; and

2.4 Implement its new FY 2012 Pell improper payment rate estimation methodology to address the issues identified in this Finding.

Response to Recommendations 2.1 through 2.4: We concur with the recommendations. As acknowledged in the report, we plan to implement wholesale changes in our FY2012 estimation methodologies for Federal Student Aid risk susceptible programs. Our new FY12 methodology for Pell will resolve the underlying issues identified by expanding upon the scope of recipients who receive Pell aid beyond those who successfully match with the IRS and SSA. The new methodology will incorporate a hybrid approach with multiple components to consider and potentially evaluate all types of Pell transactions. The Pell methodology includes three components: a baseline statistical estimate (with confidence interval) based on payment data obtained from Program Compliance teams in the field conducting current year program reviews; a supplemental point-estimate based on review of compliance audit findings; and a supplemental point-estimate based on risk-based transaction analytics. Consistent with recommendation 2.1 and 2.3, we will ensure that we fully document our plan and the results of execution of that plan before we issue the FY2012 AFR. Consistent with recommendation 2.2, we will expand upon our description of our methodologies in future AFRs.

Finding 3: The Department's Direct Loan Program Improper Payment Rate Estimation Calculation Included Components That Were Not Accurate and Complete.

Response to Finding 3: We concur that our estimation methodology for Direct Loan can be improved. We recognize limitations in our historical approach and in certain data sources used to develop our component estimates and are working to address these issues. As acknowledged in the report, we had already begun conversations with OMB and initiated planning to implement new estimation methodologies for all risk susceptible programs in FY2012 that incorporate more consistent and robust statistical analysis. In the interim, for consistency of reporting and for resource allocation purposes we coordinated with OMB for approval to continue the existing (non-statistical) methodology for FY2011 reporting for the Direct Loan program.

We appreciate the detail provided in the report on the limitations of certain data sets used and suggestions for consideration with respect to use of that data. For example, with respect to the use of historical audit data to calculate the Direct Loan disbursement component estimate, we appreciate that the report indicates that final audit determinations involving potential Direct Loan liabilities were issued to 203 schools. This is compared to 3,448 schools subject to audit that received Direct Loan disbursements for the applicable award year. As noted in the AFR, relevant audit liabilities are less than 0.01% of the total Direct Loan funds disbursed and only approximately 3% of the total Direct Loan improper payment estimate.

In addition to factors cited in the report that may understate the rate, we acknowledge too that Direct Loan-related findings from IPA audit reports may include multiple year payments or findings other than improper payments, which may result in an overstatement. One finding at one school alone, Return to Title IV Funds made late, resulted in liabilities of 9.5% of all potential Direct Loan audit liabilities for FY2010 at schools participating in the program. We recognize the imprecision in this line item estimate and, as noted in our response to the recommendations, are working to resolve.

Recommendations:

3.1 Adequately describe the methodology in the AFR on how the Direct Loan improper payment rate estimate was calculated;

3.2 Work on making improvements to the loan disbursement portion of the Direct Loan improper payment rate calculation by better matching the numerator and denominator figures by award year;

3.3 Develop corrective actions to address FFEL to Direct Loan consolidation improper payments; and

3.4 Consider results from OIG issued audit reports, FSA program reviews, and if applicable and available, OIG investigations in its Direct Loan improper payment rate estimate calculation.

Response to Recommendations 3.1 through 3.4: We concur with the recommendations. As acknowledged in the report, we are revising our FY2012 methodologies. Consistent with recommendation 3.1 (and 2.2 for Pell), we will change how we describe our estimation methodologies in the Fy2012 AFR. To ensure the reader has a full understanding of the methodology used and the precision of the estimate, we will expand on the description of the new methodology including changes from the prior year. Consistent with recommendation 3.2, we plan to replace the existing methodology referred to here for disbursements (i.e., the award year DL-related audit finding numerator over related award year funding denominator). The new DL estimation methodology leverages a hybrid approach with three components. The first component addresses the intent of this recommendation. It is a baseline statistical estimate derived from data directly obtained from Program Compliance teams in the field conducting current year program reviews. Consistent with recommendation 3.4, the second component is a supplemental point estimate that considers OIG and A-133 compliance audits. The plan recognizes and explains the limitations in this data set and the impact of these limitations on how the data is considered or used. The third component is a supplemental point estimate based on risk-based transaction analytics. Each component will explain any error identified and relate it to the relevant population (year) of payment.

We recognize the estimated improper payments attributable to FFEL to DL Consolidations are significant to the overall estimate for the Direct Loan program and, to drive substantial overall reductions, we will need to lower this component rate. Consistent with recommendation 3.3, we are working now to establish enhanced DLC incident reporting to help identify trends and issues timely to facilitate monitoring. We will meet with our business owners to consider other improvements in reporting, monitoring, and any further enhanced controls which may lead to reduction. As noted in the AFR, we also have significant controls now in place. For example, the program conducts sampling of returned funds so as to determine the root cause and conduct continuous improvement.

Finding 4: The Department Needs to Continue Its Efforts in Reducing and Recapturing Improper Payments.

Response to Finding 4: We concur with Finding 4 to continue our efforts to reduce and recapture improper payments.

Recommendations:

4.1 Update its analysis to determine whether payment recapture audits of grant and loan programs would be cost-effective in FY 2012;

4.2 Revise and implement its payment recapture audit plans for grant and loan programs based upon its updated analysis; and

4.3 Develop and implement an improper payment rate estimate for the FFEL program for FY 2012.

Response to Recommendations 4.1 through 4.3: The Department is committed to identifying and recapturing improper payments as well as preventing them to the extent possible. Consistent with ongoing efforts to better identify root causes of improper payments and develop more rigorous approaches to estimating improper payments, we concur with recommendations 4.1 and 4.2 to update our cost-benefit analyses and plans for payment recapture audits. We also concur with recommendation 4.3 to develop and implement an improper payment rate estimate for FFEL for FY 2012.

Once again, thank you for your recommendations and the opportunity to review and respond to the report.

cc: Bernard Tadley, Regional Inspector General for Audit
Teri Lewis, Assistant Regional Inspector General for Audit
Erin Hudson, Auditor
Francis Maguire, Auditor