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Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of the U.S. Department of Education (the Department) as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, and financing and the combined statements of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards and bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Department's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2005 and 2004, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented in the Management's Discussion and Analysis, required supplementary stewardship information, required supplementary information, and other accompanying information is not a required part of the basic financial statements but is supplementary information required by OMB Circular No. A-136, *Financial Reporting Requirements*. The other accompanying information has not been subjected to the auditing procedures applied in our audits of the basic financial statements and, accordingly, we express no opinion on it. For the remaining information, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 2, 2005, on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Ernst & Young LLP

November 2, 2005

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Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 2, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on internal control over financial reporting. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

In addition, we considered the Department's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the agency's internal control, determined whether internal control had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 01-02 and not to provide assurance on internal control. Accordingly, we do not provide an opinion on such controls.

With respect to internal controls related to performance measures reported in the Management's Discussion and Analysis of the Department's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

However, as a result of the procedures we did perform, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The reportable conditions are described below.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described below is a material weakness.

REPORTABLE CONDITIONS

1. Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Modified Repeat Condition)

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure and budget for the cost of federal loan programs. In implementing the requirements of the Credit Reform Act, and in complying with Federal accounting standards, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. Such costs are also re-estimated on a periodic basis. While improvements were made over the last several years, we noted that the management controls surrounding the calculation and reporting of the loan liability activity and subsidy estimates should be further refined and implemented earlier in the process to ensure that appropriate estimates are prepared. OMB Circular A-123, *Management Accountability and Control*, defines management controls as "the organization, policies, and procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making."

During fiscal year (FY) 2005, we noted that the Department continued to make progress on this reportable condition. The Credit Reform Workgroup (CRW), which was created in FY 2004 and consists of managers from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), and Budget Service, met twice in FY 2005. The primary purpose of the CRW was to inform the appropriate parties of key internal issues related to credit reform, and to manage the development of improved processes, procedures, and sources of information to enhance the credit reform estimation process.

The CRW has made progress in many areas, although the work is still ongoing. A primary focus for the upcoming fiscal year is on monitoring activities for credit reform estimates. In addition, assumption and business process subgroups will focus on efforts to ensure accurate cohort accounting within the Department's systems. The end objective continues to be a well-defined process, which includes appropriate and robust checks and edits, as well as documentation of key decisions and rationales.

However, after identifying the key improvements made or currently being made by the Department, during our testing of loan guarantees, allowance for subsidy, and subsidy cost estimates, we noted the following items that indicate management controls and analysis should be strengthened:

- The long-term cost for the credit programs is reflected in the financial statements through periodic charges for subsidy costs, adjustments or re-estimates to those subsidy costs, and loan activity, which is all recognized in the allowance for the direct loan (DL) receivable and liability for the guaranteed loan (FFEL) program. The Department uses a computer-based cash flow projection model (i.e., Student Loan Model, or SLM) and OMB calculator to calculate subsidy estimates related to the loan programs that are then recorded in the allowance for subsidy or liability account. The model uses multiple sources of loan data and hundreds of assumptions. In order to perform a check of estimates resulting from the SLM and OMB calculator, the Department prepares a backcast, which compares the model's estimates to actual activity for the current and prior fiscal years. The SLM for the prior year also produces a forecast of the expected cash flows in the current year for the outstanding loans. Rigorous comparisons of actual cash flows to the forecast prepared in the prior year (adjusted for new loans), to the backcast, and to the extent practical, recomputation of expected amounts based on loan volumes, interest rates and simplified cash flow assumptions can serve as a key detection control. The Department's efforts in this regard are evolving, and do not capture the full value of the SLM in providing a basis for robust budget to actual comparisons, or facilitate CRW participant assessments of the validity of the estimates derived by the SLM and OMB calculator. As a check, the Department should be able to reconcile the total amounts in the forecast to the allowance for subsidy and liability for loan guarantees and apply high-level analytics to assess the output.

- The early phase of the loan estimation process includes the development of the assumptions, which are used to populate the SLM with data that, in turn, feeds into the OMB calculator, which arrives at the actual cost re-estimates. In order to develop a majority of the assumptions, the Department utilizes the National Student Loan Database System (NSLDS) to extract a sample of loan data, which is known as the Statistical Abstract (STAB). The Department then executes internally developed computer programs to arrive at the assumption data that is entered into the SLM. While we understand some improvements have been made, we were informed that the programming language was not fully documented to explain the procedures executed by the programs. As a result, a review of the logic of these programs cannot be performed by someone unfamiliar with the code, which could have the potential of allowing undetected errors to exist in the development of the assumption data. Particularly in areas that have relatively less predictive capability in the existing model, we continue to advocate considering use of reasonable simplified assumptions in estimate development, which can result in simpler programs, thus establishing transparency and limiting the potential for errors.

- FFEL program receivables are classified as pre-1992 loans (liquidating account loans) and post-1991 loans (financing account loans). The Department records certain collections on each of these loan categories using an estimation process (splitter process), as this information cannot be obtained directly from cash collections. The allocation of collections between liquidating and financing loans ultimately affects the liability account for loan guarantees and accounts payable to Treasury. Currently, the Department relies primarily on the output of the credit reform model to record the net value of the pre-1992 loans. The Department should investigate methods to better evaluate whether the resulting split is occurring properly on an overall basis. The SLM develops cohort-level data and credit reform estimates, and the STAB and splitter process provide an estimate of cohort activity. The Department's financial systems are not configured to account for cash flows on a rigorous cohort level. We understand that creation of this functionality will be considered in FY 2006 by the CRW. Transition to such an approach is increasingly important to ensure that estimates in the subsidy models are appropriately adjusted as cohorts from the early 1990s wind down, and cash flows from default activities create temporary demands for cash that are currently funded on an aggregate basis across cohorts. The process may ultimately help resolve the splitter issues discussed above. In the interim, the development of additional analytical tools in this area could provide additional assurance as to whether the model is operating as intended.

Recommendations:

We recommend that the Department of Education perform the following:

1. Continue to improve the analytical tools used for the loan estimation process. Ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.

2. Document in detail the programs written to develop the assumptions for the SLM.

3. The Department, including Budget Service, should continue to develop detailed operating procedures for the loan estimation process, which would include the step-by-step procedures that take place during the various phases of the process.

4. Efforts to more fully implement cohort reporting should continue. Analytical tools should be developed to assure that the splitter process is operating as intended and that remaining credit reform estimates for each cohort are appropriate in relation to the remaining outstanding loans for such cohorts.

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

In connection with the annual audit of the Department's FY 2005 financial statements, we conducted a controls review of the information technology processes related to the significant accounting and financial reporting systems. OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* identifies five components of internal control: Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. With respect to the Control Environment and Monitoring components, GAO states that:

- "management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management," and

- "internal control monitoring should assess the quality of performance over time and ensure that the findings of audit and other reviews are promptly resolved."

While the Department has made progress in strengthening controls over information technology processes and has made improvements in the implementation of its Certification and Accreditation initiatives during FY 2005, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain repeated control weaknesses over information technology security and systems that need to be addressed. Audit resolution activity related to prior findings has generally been effective over time in addressing specific instances noted, and less so in applying lessons learned across other systems which may share similar attributes. This leads to a pattern of identifying similar findings as efforts are applied to different systems on a rotational cycle, rather than a holistic resolution of issues across all platforms.

More specifically, the Department should (1) consistently apply updates, virus/data integrity protection packages, and security patches to mission-critical systems; (2) enforce the use of complex passwords in all systems across the organization; (3) strengthen access controls to protect mission-critical systems (e.g., user provisioning process, periodic access revalidation, timely removal of user access); (4) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; and, (5) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the security weaknesses across the organization. The numerous repeat conditions noted in audit reports indicate that the control environment and monitoring components of internal control at the Department regarding information technology merit continued focus.

Recommendation:

1. Audit resolution activity has traditionally been focused around addressing the immediate security weaknesses identified by audit reports rather than a detailed evaluation of the root cause for the identified weaknesses, which is indicative of the number of repeat findings. We recommend that the Department continue its efforts to address security weaknesses disclosed in audit reports with an emphasis on identifying and addressing the root cause of the security weakness, which should decrease the likelihood of a similar security weakness being identified in future audit assessments and internal self-assessments. Examples of addressing root causes may include, but are not limited to, additional training for the information technology professionals within the organization, updates to procedures to ensure proper configuration of servers against documented hardening standards at the time of deployment, and audit performance-based contracting with vendors providing system support services to the Department.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the FY 2004 audit of the Department of Education's financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

Summary of FY 2004 Reportable Conditions

Issue Area	Summary Control Issues	FY 2005 Status
Improvements of Credit Reform Estimation and Financial Reporting Processes are Needed (Reportable Condition)	Management controls and analysis need to be strengthened over credit reform estimation and financial reporting processes.	Improvements Noted – Modified Repeat Condition Reportable Condition
Controls Surrounding Information Systems Need Enhancement (Reportable Condition)	Improvements are needed in overall information technology security management.	Improvements Noted – Modified Repeat Condition Reportable Condition

We have reviewed our findings and recommendations with Department management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated November 2, 2005.

This report is intended solely for the information and use of the management of the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

November 2, 2005

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Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheet of the U.S. Department of Education (the Department) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 2, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of the Department is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph exclusive of FFMIA disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02. We noted certain other matters involving compliance with laws and regulations that were reported to management in a separate letter dated November 2, 2005.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. We have identified the following instance of noncompliance:

While the Department has made progress in strengthening controls over information technology processes and has made improvements in the implementation of its Certification and Accreditation initiatives during fiscal year 2005, our audit work and audit reports prepared by the Office of Inspector General (OIG) identify certain repeated control weaknesses over information technology security and systems that need to be addressed. More specifically, the Department should (1) consistently apply updates, virus/data integrity protection packages, and security patches to mission-critical systems; (2) enforce the use of complex passwords in all systems across the organization; (3) strengthen access controls to protect mission-critical systems (e.g., user provisioning process, periodic access revalidation, timely removal of user access); (4) improve the configuration management process to ensure consistent security configuration of servers and mainframe security packages across the organization and improve configuration settings to comply with best practices; and (5) comprehensively review technical security weaknesses identified in prior audits in order to determine whether security controls have been fully implemented or adequately address the security weaknesses across the organization.

The Report on Internal Control includes additional information related to the financial management systems that were found not to comply with the requirements of FFMIA relating to information technology security and controls. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management concurs with our recommendations and, to the extent findings and recommendations were noted in prior years, has provided a proposed action plan to the OIG in accordance with applicable Department directives.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of the Department, OMB, Congress, and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

November 2, 2005