Management’s Assurances

Federal Managers’ Financial Integrity Act of 1982 (FMFIA)

FMFIA requires that agencies establish internal controls and financial systems that provide reasonable assurance that the integrity of Federal programs and operations is protected. It requires that the head of the agency provide an annual assurance statement as to whether the agency has met this requirement. Appendix A of OMB Circular A-123 provides specific requirements for conducting management’s assessment of internal control over financial reporting, and also requires the agency head to provide an assurance statement on the effectiveness of internal controls over financial reporting.

The Department’s rigorous FY 2012 assessment of internal controls identified two material weaknesses with Federal Student Aid servicing systems. These weaknesses reflect, in aggregate, a number of internal control deficiencies that resulted from system functionality issues occurring after large-scale system conversions in October 2011. The conversions involved extensive data transfers under two information technology system contracts. The systems—currently operated under contracts with Xerox, Inc.—help track and report on data from the Direct Loan and Federal Family Education Loan (FFEL) programs. Within the Department, these two contracts with the conversion challenges are known as: 1) ACS, Inc. Education Servicing (ACES); and 2) Debt Management Collection System (DMCS2).

Material Weakness in Internal Controls Over Financial Reporting of Federal Student Aid Data

The Department’s management teams responsible for implementation and oversight of these systems identified multiple internal control deficiencies with ACES and DMCS2 as a result of the system conversions that may adversely impact the accuracy of financial reporting, to include the reporting of loan balances, fund balance with Treasury, and suspense account balances; the processing of portfolio and cash reconciliations; and qualified Service Organization Control 1 (SOC 1) Reports. As of June 30, 2012, in management’s judgment these reportable conditions, in the aggregate, would result in more than a remote likelihood that a material misstatement of the Department’s financial statements would not be prevented or detected—if the conditions remained uncorrected.

Since June 30, 2012, the Department has taken aggressive action to correct these financial reporting deficiencies. Federal Student Aid (FSA) management actively monitored and tracked system functionality issues and worked closely with Xerox, Inc. to fully examine root causes, impacts, and affected processes. The Department took a number of corrective actions.

To correct inaccurate loan balances, FSA implemented a number of system fixes, and researched and corrected borrower balances. FSA conducted and eliminated a backlog of portfolio and cash reconciliations, and evaluated and corrected suspense account balances by adjusting the matching process. FSA also implemented other internal control improvements that resulted in system fixes, restored system functionality, and reduced backlogs (including administrative wage garnishment and Treasury offset to improve collections, rehabilitation of loans and transfer of loans to continue servicing, and file processing).

As a result of these aggressive actions, as of September 30, 2012, the Department is confident these corrective actions have reduced the potential adverse impacts of the underlying reportable conditions such that, in the aggregate, they do not result in more than a remote
likelihood that a material misstatement of the financial statements in this report would not be prevented or detected. In management’s judgment, in the aggregate these reportable conditions and the potential errors that may fail to be prevented or detected are below the level that is material. Reportable conditions remain; however, the Department continues to take these remaining reportable conditions and potential errors very seriously and continues to take aggressive corrective action to fully resolve them.

**Material Weakness in Internal Controls Over Operation of Direct Loan and FFEL Programs**

The internal control deficiencies related to ACES and DMCS2 impact multiple internal control objectives. In addition to internal control over financial reporting, some of these deficiencies impact internal control over the effectiveness and efficiency of operations. These include issues with the acceptance of loan assignments, transfers, and collection activities. These issues result in material weaknesses for FMFIA Section 2 reporting, for the year ended September 30, 2012.

The Department has taken similarly aggressive actions to begin to correct the root causes of these internal control deficiencies, but in management’s assessment the outstanding deficiencies in this area, in the aggregate, remain significant as of September 30, 2012. These actions will continue into 2013 and include research into borrower balances and root cause analysis of system limitations to inform recommendations on system and process fixes.

**Federal Financial Management Improvement Act of 1996 (FFMIA)**

FFMIA requires that agencies implement and maintain financial management systems that comply substantially with the Federal financial management system requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. The agency head is to make an annual determination whether the financial systems substantially comply with FFMIA.

On account of the outstanding internal control deficiencies associated with the ACES and DMCS2 financial systems that affect financial reporting, the Secretary has determined the Department’s financial systems do not substantially comply with all FFMIA requirements as of September 30, 2012. The previously described deficiencies that continue to impact borrower data elevate the risk of the Department’s financial systems to a moderate level. In addition, the Department’s assessment identified a number of system-related internal control deficiencies including: security management and user access issues (e.g., user access documentation, security awareness training, review and termination of inactive users, security documentation), application-level issues (e.g., change control, logging and monitoring, password parameters), and business process issues related to dormant data, edit checks, and transaction data processing. The Department believes the combination of these deficiencies support the non-compliance determination.

Consistent with OMB Circular A-123 requirements, the Department’s plans for bringing all financial systems—namely ACES and DMCS2—into substantial compliance with FFMIA are summarized in the previous section. These efforts will increase the reliability and timeliness of financial information for managing current operations. The Department also will continue efforts to address security and control weaknesses with an emphasis on addressing their root cause uniformly across the organization. The goal of this action is to decrease the likelihood of similar weaknesses.
The Department continues to meet other key criteria for compliance with FFMIA:

- Financial statements, both annual and quarterly presentations, and other required financial and budget reports are prepared using information generated by the Financial Management Support System (FMSS); and

- The FMSS operations and procedures remain consistent with Federal accounting standards and comply with the U.S. Government Standard General Ledger guidance at a transactional level.
Federal Managers’ Financial Integrity Act and Federal Financial Management Improvement Act

Federal Managers’ Financial Integrity Act

The Department of Education’s management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers’ Financial Integrity Act of 1982 (FMFIA). The Department conducted its assessment of the effectiveness of internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations in accordance with OMB Circular A-123, Management’s Responsibility for Internal Control. Based on the results of this evaluation, the Department identified a material weakness in internal controls over the operation of the Direct Loan and FFEL programs. For all other program areas, the Department can provide reasonable assurance that internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations as of September 30, 2012, was operating effectively; no other material weaknesses were found in the design or operation of the internal controls.

In addition, the Department conducted its assessment of the effectiveness of internal controls over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123. Based on the results of the evaluation, the Department identified a material weakness in internal controls over financial reporting of student loan data as of June 30, 2012. However, corrective actions were taken and, as of September 30, 2012, the Department can provide reasonable assurance that its internal controls over financial reporting were operating effectively and no material weaknesses were present in the design or operation of the internal controls.

Federal Financial Management Improvement Act

The Federal Financial Management Improvement Act of 1996 (FFMIA) requires agencies to implement and maintain financial management systems that are substantially in compliance with Federal financial management systems requirements, Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. Based on the results of the Department’s assessment and outstanding internal control deficiencies, the Department’s financial management systems do not substantially comply with FFMIA as of September 30, 2012.

/s/
Arne Duncan
November 16, 2012