Report of the Independent Auditors

UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

NOV 16 2012

The Honorable Arne Duncan
Secretary of Education
Washington, D.C. 20202

Dear Secretary Duncan:

The enclosed reports present the results of the annual audits of the U.S. Department of Education's financial statements for fiscal years 2012 and 2011 to comply with the Government Management Reform Act of 1994 (GMRA). The reports should be read in conjunction with the Department's financial statements and notes to fully understand the context of the information contained therein.

We contracted with the independent certified public accounting firm of Ernst & Young, LLP (Ernst & Young) to audit the financial statements of the Department as of September 30, 2012 and 2011, and for the years then ended. The contract required that the audits be performed in accordance with U.S. generally accepted government auditing standards and OMB's bulletin, *Audit Requirements for Federal Financial Statements.*

In connection with the contract, we monitored the performance of the audits, reviewed Ernst & Young's reports and related documentation, and inquired of its representatives. Our review was not intended to enable us to express, and we do not express, an opinion on the Department's financial statements, or conclusions about the effectiveness of internal control, whether the Department's financial management systems substantially complied with the Federal Financial Management Improvement Act of 1996, or on compliance with laws and regulations.

Ernst & Young is responsible for the enclosed auditor's report and the conclusions expressed in the related reports on internal control and compliance with laws and regulations. Our review disclosed no instances where Ernst & Young did not comply, in all material respects, with U.S. generally accepted government auditing standards.

Sincerely,

Kathleen S. Tighe

Kathleen S. Tighe
Inspector General

Enclosures

The Department of Education's mission is to promote student achievement and preparation for global competitiveness by fostering educational excellence and ensuring equal access.

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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, 2012 and 2011, and the related consolidated statements of net cost, and changes in net position, 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. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. 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 audits 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, 2012 and 2011, and its net cost, changes in net position, and budgetary resources, for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 16, 2012, 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

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integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the United States require that the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information as identified on the Contents page of the Department's Agency Financial Report, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Federal Accounting Standards Advisory Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Department's basic financial statements. The other accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we do not express an opinion or provide any assurance on it.

Ernst + Young LLP

November 16, 2012

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Report on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

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, 2012, and the related consolidated statements of net cost, and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 16, 2012. 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. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

Management of the Department is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04, as amended. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. However, as discussed below, we identified a deficiency in internal control over financial reporting that we consider to be a material weakness and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the entity's financial statements

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will not be prevented, or detected and corrected on a timely basis. We consider the first deficiency described below to be a material weakness.

A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the second and third deficiencies described below to be significant deficiencies.

MATERIAL WEAKNESS

1. Controls Surrounding the Department's Debt Management Collection System and ACS, Inc. Education Servicing System Need Improvement.

DMCS2
The Department utilizes a debt management collection system to manage defaulted student loans and grant overpayments that require reimbursement. The system facilitates the storage, retrieval, and editing of debtor information and uses this information to help collect defaulted loans and grant overpayments. When direct loans and Department-held FFEL loans being serviced by the Department's loan servicers reach 360 days of non-payment, they are transferred to the Department's Debt Management Collection System (DMCS2). Similarly, defaulted guaranteed loans being collected by the guaranty agencies are to be transferred to the Department's DMCS2 after meeting certain criteria. Under certain circumstances, grants (including Pell Grants) may need to be repaid if a student withdraws from school, or under certain other circumstances where a student receives a grant greater than they are entitled to receive. The Department began transitioning from its legacy debt collection system to DMCS2 in late FY 2011, with the system conversion largely occurring in October 2011 (early FY 2012).

The Department has experienced significant difficulties with DMCS2 during FY 2012, including the inability of the system to process certain types of transactions, the untimely preparation of certain reconciliations, inadequate transaction processing related to the reporting of Fund Balance with Treasury, untimely reporting of interest accrual calculations, untimely reporting of transactions from DMCS2 to FMS, and ineffective oversight of the Department's contractors responsible for the servicing system. In addition, IT general controls and business process controls surrounding the system were considered ineffective during the year, as evidenced by receiving a qualified opinion on the Service Organization Control (SOC-1) report from the service auditor for the DMCS2 system. The Department and its contractors devoted substantial time and effort during the fiscal year and beyond to remedy and/or alleviate the significance of such issues, with progress being made in many areas. However, certain issues existed for the majority of the fiscal year and others have continued past the end of FY 2012. In addition, these

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issues resulted in several errors in financial reporting that impacted the draft financial statements and notes. The remainder of this section discusses these issues.

Issues with System Functionality
As the Department began utilizing DMCS2 in FY 2012, problems with the functionality of certain aspects of the system became apparent. For example, the processing of rehabilitated loans, where borrowers have met the requirements to bring their loans out of default status through making a series of 9 voluntary on-time payments within 10 months, did not begin functioning until late April 2012. As a result, loans which should have been transferred out of DMCS2 and to other loan servicers were not able to be transferred out for more than the first half of FY 2012. In addition, the Department was unable to initiate new Treasury Offset Program (TOP) collections until February 2012 or make administrative wage garnishments (AWG) for newly defaulted borrowers until approximately June 2012. In some instances, such as with AWG, management informed us that they had not tested all of the functionality of the system for procedures related to the entire wage garnishment life cycle prior to the DMCS2 system conversion as the amount of time required to do so would have been prohibitive. Additionally, certain requirements of the system are not yet fully functional and do not work under all scenarios.

Loans meeting the criteria for default were not transferred to DMCS2
Certain direct loan receivables that met the criteria for default could not be accepted into DMCS2. These principally relate to re-defaulted loans, which are loans which previously defaulted, were rehabilitated and assigned to a loan servicer for normal loan servicing, and have subsequently defaulted again. Management informed us that while active borrower accounts were converted from the legacy system to DMCS2, information from zero balance and closed borrower accounts is not on DMCS2 and still currently resides on the legacy system. Since the historical information on these previously closed accounts is not available on DMCS2, the system is currently unable to accept these re-defaulted accounts. As of September 2012 there were approximately $1.1 billion of direct loans receivable which should have been transferred to DMCS2 which were residing on other loan servicing systems. We noted that management did not take these defaulted direct loans receivable into account when preparing its draft financial statement note disclosure regarding the amount of defaulted direct loans receivable, which resulted in an understatement of the amount of defaulted direct loans in the note disclosure. Management subsequently corrected the note disclosure.

In addition, certain defaulted guaranteed loans under the FFEL program which have met the criteria for mandatory assignment to DMCS2 have not been transferred. At management's request, the guaranty agencies are continuing to pursue collection of these defaulted loans. Management anticipates that these defaulted guaranteed loans will be transferred to DMCS2 during FY 2013. As of September 2012, there were approximately $1.9 billion of defaulted guaranteed loans that met the criteria for assignment to DMCS2 but have not yet been transferred.

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Loan portfolio reconciliations were not completed timely
Many reconciliations between DMCS2 and the FMS sub ledger were not completed on a timely basis, within management's guidelines for completing reconciliations within 45 days after month-end. We noted that over 40% of the loan portfolio reconciliations for DMCS2 principal, interest, and fees were completed late during FY 2012, including nearly half of the principal reconciliations. These reconciliations, which are completed monthly for each loan program / fund code, are an important detect internal control tool to identify errors and anomalies. However, completing the preparation and review of such reconciliations substantially after management's stated timeframes decreases their utility. We noted improvement in the timely completion of reconciliations near the end of FY 2012.

Fund Balance with Treasury
The Department's loan servicers have access to the Department's reconciliation tool for Fund Balance with Treasury (FBWT) and should be accessing the tool daily to resolve unmatched differences between amounts reported by Treasury and amounts reported from the servicing system to FMS and FMSS. In addition, borrower payments are initially recorded in the Department's suspense fund, and the summary deposit is then applied to the borrower's account and posted to the appropriate fund code. During FY 2012, DMCS2 was unable to timely and consistently perform these functions, resulting in thousands of schedules that were unmatched or in suspense at any point in time. Most borrower payment transactions are expected to be applied in 1-2 business days. Management has established a monitoring metric with its servicers that less than 5% of FBWT schedules should be unmatched for over 60 days. DMCS2 was consistently unable to meet these thresholds during FY 2012.

Untimely interest accruals
After implementing DMCS2, the Department recorded an interest accrual in the first quarter of FY 2012 related to FY 2011 and prior years that was calculated by DMCS2. This amount had not been previously accrued in FY 2011 or prior years, but was recorded in FY 2012. Additionally, it was noted that interest on DMCS2 loans receivable was not being calculated through September 30, 2012. Instead, the system calculated interest through the date of last activity on the borrower's account during the month of September 2012. This resulted in an under-accrual of interest as of September 30, 2012. Changes in the timing of interest accruals have no net effect on the Department's primary financial statements. In addition, no budgetary resources or status of resources are affected, including expended and unexpended obligations. The amounts reported in certain footnote disclosures are impacted by the timing of the interest accruals; however, such changes, while enhancing the accuracy of the information in the disclosures, do not have a material impact on the fair presentation of the financial statements. Consequently, the Department did not make any adjustments for these items. However, management had not performed a rigorous and comprehensive analysis to arrive at these conclusions during the financial statement close process or in drafting the current fiscal year financial statements.

Untimely reporting of financial transactions from DMCS2 to FMS
During the year, DMCS2 did not timely report all financial transactions to the FMS system, which is analogous to a sub-ledger used to record loan-related transactions. Data from FMS is transmitted to the FMSS general ledger. During much of FY 2012, DMCS2 was unable to completely or timely submit daily accounting files to FMS within 24 hours, and was unable to submit other required monthly detail files to FMS, including records of loans transferred in or out. In addition, in reviewing reconciliations between DMCS2 and FMS, we noted that certain duplicate files were transmitted to FMS, while other files were not transmitted and accepted by FMS.

Ineffective IT Controls
A SOC-1 report on the DMCS2 application was prepared for the period January 1 to June 30, 2012. The service auditors issued a qualified opinion on the DMCS2 application and noted several weaknesses within information technology security and systems that need to be addressed, including deficiencies in the areas of change management, administrative access, and data transmission / encryption. Specifically, deficiencies in change management included inappropriate access to migrate changes to the production environment, lack of approval for changes prior to implementation, and the lack of post-implementation reviews of the changes. Additionally, administrative access was not restricted to authorized individuals. Further, data transmissions were not appropriately monitored, and the encryption of sensitive information across data transmissions was not appropriate.

In addition, we also noted that the service auditors had identified deficiencies in the following business process control areas related to the service organization: (1) correspondence related to borrowers' loan discharge requests was not processed completely, accurately and in a timely manner; and (2) loan assignment activities were not processed completely, accurately and in a timely manner.

ACS, Inc. Education Servicing System (ACES)
The Department's legacy direct loan servicer transitioned from its legacy servicing system to a new loan servicing system, ACES, at the beginning of FY 2012. The Department has experienced difficulties with the transition to ACES during FY 2012, including the incorrect processing of certain types of transactions by the system, the untimely preparation of certain reconciliations, and inadequate transaction processing related to the reporting of Fund Balance with Treasury. In addition, the SOC-1 report for the ACES imaging system, Panagon, covering the period January 1 to June 30, 2012 was qualified. In their qualification, the service auditors noted several weaknesses and deficiencies in the areas of change management (inappropriate access to migrate changes to production), administrative access (with access not being restricted to authorized personnel), and the lack of timely and complete processing of deferments, student status confirmation records, and forbearances. During our confirmation of borrower loan balance procedures, we noted several borrowers with unusually large balances. When we inquired of management regarding these items, we were informed that certain loan balances were

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misstated as the ACES system had not correctly processed all aspects of reapplication transactions that relate to a prior fiscal year.

Management's Self-Assessment of Internal Control and Financial Management Systems
The Department performs an annual self-assessment of its internal control over financial reporting as part of OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A, and is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA). As part of this process for FY 2012, the Department self-identified the issues with DMCS2 and ACES as a material weakness as of June 30. Additionally, the Department reported a non-conformance with FMFIA Section 4 as of September 30, resulting in non-compliance with certain requirements of the Federal Financial Integrity Act.

Recommendations:

We recommend that the Department of Education perform the following:

1. Ensure that the DMCS2 servicer resolves and completes the remaining system requirements in order to bring DMCS2 to a fully operational status. In the interim, establish temporary work-around solutions for the remaining requirements, where applicable.
2. Complete system fixes to resolve the issues surrounding interest accruals (DMCS2) and incorrect loan balances (ACES). If necessary, establish temporary work-around solutions to ensure that interest will be appropriately recorded on the Department's interim and year-end financial statements.
3. Review controls and operating procedures related to the Service Organization and understand the demarcation of the control environment between the servicer and the Department.
4. Require conformance and effectiveness of the previously noted controls and coordinate closely with the servicer to closely manage progress, status and corrective actions.
5. Improve contract management and oversight of contractors on mission critical systems especially as it relates to servicers and providers that provide the Department or FSA with a Service Organization Control (SOC 1) report.

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SIGNIFICANT DEFICIENCIES

2. 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 net costs are also re-estimated on a periodic basis. While improvements have been made over the last several years, we noted that internal controls and processes surrounding the calculation and reporting of the loan liability activity and allowance for subsidy estimates should be maintained and further refined to ensure that appropriate estimates are prepared.

During the last few years, the Department has been challenged by the enactment of several pieces of legislation, as *Ensuring Continued Access to Student Loans Act of 2008* (ECASLA) and *Student Aid and Financial Responsibility Act* (SAFRA), that have had a significant impact on the Department's loan programs. SAFRA provided that no new FFEL loans were originated after June 30, 2010 increasing the Department's responsibility for originating federal student loans, primarily through the William D. Ford Federal Direct Loan program (direct loan program). As part of this process, the Department has spent significant time and effort managing the transition to the direct loan program, which has resulted in a significant increase in direct loans during FY 2011 and FY 2012. The Department brought together representatives from throughout the organization to implement and administer the activities surrounding the transition to direct lending and the wind-down of the other programs. Representatives included individuals from the Office of the Chief Financial Officer (OCFO), Federal Student Aid (FSA), and Budget Service.

OMB A-11, *Preparation, Submission, and Execution of the Budget*, the Credit Reform Act and other accounting guidance strongly recommend that agencies be able to analyze loan portfolios at the cohort level. The Department's financial systems are not configured to account for cash flows on a precise cohort level; consequently, over the last several years the Department developed and refined a methodology to analyze and maintain student loan activity at the origination cohort level. The result of this analysis, the cohort analysis tool, is currently the Department's primary repository of cohort-level data. Another tool, the forecast, consists of expected cash flows, that, when discounted, can be used to compare to the recorded activity in the general ledger and point out variances. Using the cohort analysis tool, the Department has been able to research any variances and demonstrate that balances in the Department's financial records are supported by its estimates.

After identifying the challenges faced by the Department and the key improvements made or being made by the Department, we noted the following items that indicate management controls and analysis can 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 receivables related to the direct loan program and the temporary loan purchase authority, and in the liability for the guaranteed loan (FFEL) program. The loan activity that flows through this allowance and liability is determined by the accounting standards and it is accounted and reported by the Department using business object classes. Recent programs changes have required the Department to reorganize many of these object classes to better account for the new conditions. During our review of the allowance and liability activity for the last several years, we have identified large and unusual fluctuations that the Department didn't note in their review and was unable to explain. Our inquiries caused the Department to initiate their analysis which eventually found misclassifications that required re-classes to the notes of the financial statements. The Department prepares monthly analytical reports that, among other things, presents and analyzes changes in the object class activities related to these loan programs. Additionally, the Department occasionally conducts Credit Reform Work Group (CRWG) meetings where different area managers get together to discuss the reasonableness of the credit reform estimates based on their experiences with the actual program activity. Holding more frequent CRWG meetings which focus on these analytical reports to have robust discussions about loan activity and the impact on the estimates can serve as a strong internal control.
- 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 accounts. The model uses multiple sources of loan data and hundreds of complex 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 also produces a forecast of the expected cash flows in the current year for the outstanding loans which, when discounted, can be used to compare to the recorded activity in the general ledger. Comparisons using the backcast and forecast tools, and to the extent practical, recomputation of expected amounts based on loan volumes, interest rates, and simplified cash flow assumptions, can serve as key detect controls for potential undetected errors that may exist in the development of the assumption data and credit reform estimates. During our testing, we noted that management has no formal detailed review procedures surrounding the input of the many variables into the SLM, the input of cash flows into the OMB calculator or the process surrounding the analytical tools. Management does perform a high-level review of such data; however, this review is not sufficient to identify errors that may occur at a detailed level. For example, after the current year's financial statements were

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prepared, management noted an inconsistency in the re-estimate between interest rate and technical and default that resulted in a reclassification on the notes to the financial statements. Additionally, we noted calculation errors in certain of the analytical tools used by the Department, including the back of the envelope reasonableness analytical tool. While these calculation errors in certain analytical tools did not directly impact amounts in the financial statements, the analytical tools should contain accurate information if they are to serve their purpose as a detect internal control. Implementing a detailed review process may reduce the potential for errors occurring in all aspects of this complex re-estimate and also in the analytical tools.

- 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 many of the assumptions, the Department utilizes the National Student Loan Database System 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. During our review of the development of the death, disability and bankruptcy (DD&B) assumption, we noted that in FY 2012 the Department did not calibrate the NSLDS data to other general ledger or any other sources as done in prior years as part of the data quality control. The Department should consider developing calibrating processes to ensure data quality and model accuracy. Additionally, during our review of the default assumption development, we noted that the process by which defaults are estimated for FFEL loans was modified to separately account for loans that are repurchased from the Asset-Backed Commercial Paper Conduit program as they appear to have higher default rates than the other FFEL loans. We consider this approach to be reasonable, however, we noted that while the documentation describes the need to adjust the actual default rates downward due to expected increase in future repurchases, the adjustment factor is not described or justified in the documentation. The Department should consider documenting a rationale for choosing this adjustment factor as well as document any supporting analyses. Furthermore, during our review of the Teacher Loan Forgiveness (TLF) assumption development, we noted that a change in the methodology included a "take-up factor" to reflect the fact that not all eligible teachers will apply for the forgiveness to which they are entitled. We note that the determination of the "take-up factor" is highly judgmental, and, while the approach is generally reasonable, would benefit from additional discussion, justification and documentation. Also, we noted further opportunities for documentation improvements in this area. For example, the TLF projections are performed using Excel worksheets, using the calculations generated by the SAS programs. This documentation could be enhanced by including a description of the purpose of each worksheet, description of formulas used, and how each work step corresponds to the methodology.

- Consistent with credit reform implementation guidance, the Department relies significantly on prior patterns to estimate future cash flow activity. However, the

Department should be more proactive in identifying conditions in which a refinement of such estimates should be made when circumstances suggest that fundamental patterns will change. For example, to the extent that lender or borrower behavior appears likely to have changed, or be changing, deviations from the use of historical data, or consideration of additional information to capture the impact of such changes, may be warranted in developing credit reform estimates. The current economic conditions, including high unemployment, reductions in credit availability for borrowers, and declines in home prices may have a significant impact on student loan borrowers and consequently on the Department's credit reform results. Many of these impacts have not been explicitly reflected in the Department's estimates. During our review of the development of the DD&B assumption, we noted a change in the calculation of the FFEL bankruptcy rates where weighted averages are calculated using only the last four-year period rates in order to capture the most recent economic trends. While this approach is reasonable, the Department may want to consider evaluating the selection of time period used for weighted average calculations on a periodic basis as economic conditions change.

- Management's assessment of internal control over financial reporting required under OMB Circular A-123, *Management's Responsibility for Internal Control*, Appendix A may also provide management with an additional opportunity to objectively review its controls over the credit reform estimation process by individuals independent of the process. During FY 2011 and 2012, the Department did not test controls surrounding the credit reform estimation process and instead the Department focused on evaluating the adequacy of existing controls and identifying potential control gaps. To the extent that management is able to leverage the testing performed under OMB A-123, Appendix A, such results may provide additional feedback in refining and improving controls over the estimation process.

Recommendations:

We recommend that the Department of Education perform the following:

1. Continue to improve the analytical tools used for the loan estimation process, working to develop formats and content that synthesize and capture loan level data available in the Department's systems. Specifically:
    - Critically assess death, disability and bankruptcy rates and other assumptions by cohort in light of recent changes in the economic environment to determine the extent to which there may be differences in performance across cohorts.
    - For a subset of borrowers, obtain credit rating data and track the borrower's ability to pay over time. Utilize the results for further analysis.
2. Increase the frequency of the CRWG meetings and take full advantage of their analytical reports to have robust discussions about loan activity and the impact on the estimates with different area managers.

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3. Implement formal detail review procedures over the input of variables into the SLM, input of cash flows into the OMB calculator and other calculations surrounding the process to avoid potential errors that may negatively affect the re-estimates. Also, perform a detailed review of the input of source data included in the Department's analytical tools to avoid errors and ensure that all analytical tools reconcile with one another to allow for their use as detect controls for loan program cost estimates.

4. Strengthen the documentation related to assumption development, including documentation, discussion and rationale of changes in the methodologies. Furthermore, improve documentation detail by including a description of the purpose of worksheets, description of formulas used, and how each work step corresponds to the methodology. Additionally, consider developing calibrating processes to ensure data quality and model accuracy.

5. Consider the impact of changes in general economic conditions when developing assumptions. Evaluate the selection of time periods used for weighted average calculations on a periodic basis as economic conditions change.

6. Consider ways to better leverage management's efforts under Appendix A of OMB Circular A-123 as a way to provide additional focus and attention to the controls surrounding the credit reform estimation process.

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

In connection with the annual audit of the Department's FY 2012 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 Revised, *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 uniform and consistent internal information resource management policies and procedures and oversee the development and promote the use of information management principles, standards, and guidelines, evaluate agency information resources management practices in order to determine their adequacy and efficiency; and (4) determine compliance of such practices with the policies, principles, standards, and guidelines.

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, the GAO publication 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 worked toward strengthening and improving controls over information technology processes during FY 2012, our audit work and audit reports prepared by the Office of Inspector General (OIG) continue to identify certain control weaknesses, including repeat conditions, within information technology security and systems, that need to be addressed. During our review of IT general controls at the Department and FSA, we identified deficiencies in the following areas: (1) access for terminated users was not removed in a timely manner or not removed at all; (2) revalidation of users' rights is not consistently performed for all applications and users, and for those revalidations that are performed, we noted instances in which there was no validation of the appropriateness of user access or users were not revalidated by the appropriate members of management; (3) documentation and related approvals required to provision user access are not consistently maintained; (4) accounts with elevated administrative access being shared without appropriate monitoring or review procedures; (5) IT General Control issues indicated in Service Organization Control (SOC-1)[1] reports for key applications across change management, user access and privileged user access.

The OIG has identified information technology-related deficiencies for the Department and FSA in reports issued during FY 2012, including its FY 2012 Federal Information Security Management Act (FISMA) review, and Education Central Automated Processing System (EDCAPS) Information Security Audit. In its EDCAPS Information Security Audit report, the OIG noted the following:

1. Risk management framework is not sufficiently designed or implemented to address risk from an organizational perspective and reflect change within the system in a timely manner.
2. Monitoring and oversight controls were not sufficiently implemented to address patch management control deficiencies.
3. Security controls weaknesses existed for hardware and software configurations.
4. Monitoring controls are not sufficiently designed to ensure that corrective actions for incidents are taken in a timely manner and properly documented.

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[1] Please refer to the Material Weakness related to Debt Management and Collection including the DMCS2 application.

5. Configuration Management Database was not adequately maintained and updated to track EDCAPS hardware changes.
6. Security configuration baselines have not been established for operating systems, databases, and network infrastructure devices used for EDCAPS.
7. Business application control procedures are not sufficient to ensure ongoing monitoring of information system connection.

In addition, the OIG FISMA Audit reports note issues related to compliance with National Institute of Standards and Technology (NIST) 800-37 guidelines, including in the areas of Configuration Management, Identity and Access Management, Incident Response and Reporting, Risk Management, Security Training, Plan of Action and Milestones, Remote Access Management, and Contingency Planning. In addition the OIG FISMA audit report noted that the areas noted as being non-compliant relate to agency-operated and contractor-operated systems; whether systems are contractor-operated or agency-operated, all Departmental systems reported in the system's inventory are required to comply with security requirements set forth by FISMA OMB and NIST.

Several of the above deficiencies are repeat conditions (although for different platforms or systems) that were noted in our work and in the OIG's audit reports, an indication that the control environment and monitoring components of internal controls at the Department require additional focus.

Recommendations:

Applications and related infrastructure are supported by a number of separate groups within the Department and FSA. While these groups have attempted to implement controls promulgated by Department, FSA, OMB, and NIST guidelines, control processes and practices continue to be implemented in a disparate manner across these groups. In addition, audit resolution activities have traditionally been performed by each separate group and have largely focused around addressing the immediate security and control weaknesses identified by audit reports. While the OCIO has begun to implement a comprehensive risk management program across the Department and FSA, we noted that in FY 2012 these efforts have not yet allowed for a consistent control environment.

We recommend that the Department continue its efforts to address security and control weaknesses disclosed in audit reports or identified in internal self-assessments with an emphasis on addressing the root cause of the security or control weakness uniformly across the organization, which should decrease the likelihood of similar weaknesses 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, allocating appropriate resources and subject matter resources to information technology process areas, maintaining updated procedures to ensure proper configuration of servers against documented standards at the time of changes in the environment, and monitoring of contract performance of vendors providing system support services to the Department. As the Department migrates existing IT systems to vendors, additional focus in contracts the Department executes with service providers is required to monitor and achieve compliance with Departmental and Federal guidelines.

More specifically, the Department should: (1) strengthen access controls to protect mission-critical systems (e.g., periodic access revalidation, timely removal of user access, and enforcement of changes in access due to changes in roles and responsibilities); (2) 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 Department and FSA policy; (3) enhance its security training and awareness program, specifically around actions to be taken in the event an employee encounters suspicious activity; (4) revise current methods of identifying and logging suspicious activity as it relates to unauthorized access to accounts and data; (5) improve incident response and reporting procedures; (6) improve contract management and oversight of contractors on mission critical systems especially as it relates to servicers and providers that provide the Department or FSA with a Service Organization Control (SOC 1) report; and (7) holistically address the information systems environment throughout the Department and implement improvements by considering the vulnerabilities and corrective actions reported for the organization as part of the POA&Ms system and reports.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the FY 2011 audit of the U.S. 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:

<u>Summary of FY 2011 Significant Deficiencies</u>

Issue Area	Summary Control Issue	FY 2012 Status
Continued Focus on Credit Reform Estimation and Financial Reporting Processes is Warranted (Significant Deficiency)	Management controls and analysis need to be strengthened over credit reform estimation and financial reporting processes.	Modified Repeat Condition classified as a Significant Deficiency
Controls Surrounding Information Systems Need Enhancement (Significant Deficiency)	Improvements are needed in overall information technology security and systems.	Modified Repeat Condition classified as a Significant Deficiency

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We have reviewed our findings and recommendations with Department management. Management generally concurs with our findings and recommendations in their response and will provide a corrective action plan to the OIG in accordance with applicable Department directives. We did not audit management's response and, accordingly, we express no opinion on it.

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 16, 2012

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Report on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

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, 2012, and the related consolidated statements of net cost, and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and have issued our report thereon dated November 16, 2012. 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. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

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. 07-04, as amended, 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. 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.

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 or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04, as amended.

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.

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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:

During FY 2012, the Department performed large scale systems conversions for two loan servicing systems – Debt Management Collection System (DMCS2) and ACS, Inc. Education Servicing (ACES). The Department experienced significant IT issues with these systems, including a qualified Service Organization Control (SOC-1) report on the DMCS2 application for the period January 1 to June 30, 2012. The SOC-1 report noted several weaknesses within information technology security and systems that need to be addressed. We noted that the service auditors identified deficiencies in the areas of change management, administrative access, and data transmission / encryption. Specifically, deficiencies in change management included inappropriate access to migrate changes to the production environment, lack of approval for changes prior to implementation, and the lack of post-implementation reviews of the changes. Additionally, administrative access was not restricted to authorized individuals. Further, data transmissions were not appropriately monitored, and the encryption of sensitive information across data transmissions was not appropriate. We also noted that the service auditors had identified deficiencies in the following business process control areas related to the service organization: (1) loan correspondence related to discharge requests was not processed completely, accurately and in a timely manner; and (2) loan assignment activities were not processed completely, accurately and in a timely manner. Similarly, the SOC-1 report for the ACES imaging system, Panagon, covering the period January 1 to June 30, 2012 was also qualified. In their qualification, the service auditors noted several weaknesses and deficiencies in the areas of change management (inappropriate access to migrate changes to production), administrative access (with access not being restricted to authorized personnel), and the lack of timely and complete processing of deferments, student status confirmation records, and forbearances. In addition, we and management noted additional deficiencies surrounding other aspects of these systems, including incorrect loan balances, Fund Balance with Treasury, suspense account balances, and late portfolio reconciliations. Based on the deficiencies noted, management considered ACES and DMCS2 financial systems not in conformance with Section 4 of the Federal Managers' Financial Integrity Act (FMFIA) as of September 30, 2012, and also identified these items as a material weakness in internal control over financial reporting as of June 30, 2012 as part of its OMB Circular A-123 Appendix A self-assessment. A Section 4 non-conformance under FMFIA also results in non-compliance with FFMIA federal financial management systems requirements.

Our Report on Internal Control dated November 16, 2012, 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 internal 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

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Report on Compliance and Other Matters
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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. We did not audit management's proposed action plan and, accordingly, we express no opinion on it.

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 16, 2012

UNITED STATES DEPARTMENT OF EDUCATION

NOV 14 2012

MEMORANDUM

TO: Kathleen S. Tighe
Inspector General

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

Danny A. Harris, Ph.D.
Chief Information Officer

SUBJECT: DRAFT AUDIT REPORTS
Financial Statement Audits for Fiscal Years 2012 and 2011
U.S. Department of Education
ED-OIG/A17M0001

Please convey our sincere thanks and appreciation to everyone on your staff who worked diligently on this financial statement audit. The Department reviewed the draft Fiscal Years 2012 and 2011 Financial Statement Audit Reports. Without exception, we concur and agree with the Report of Independent Auditors and the Report on Internal Control. We also concur and agree with the Report on Compliance with Laws and Regulations.

We will share the final audit results with responsible senior officials, other interested program managers, and staff. At that time, we will also request the preparation of corrective action plans to be used in the resolution process.

Again, please convey our appreciation to everyone on your staff whose efforts permitted the Department to complete the audit within the established timeframe.

Please contact Gary Wood, Director, Financial Management Operations, at (202) 245-8118 with any questions or comments.

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