



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

December 11, 2013

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

Dear Secretary Duncan:

The enclosed reports present the results of the audit of the U.S. Department of Education's (Department) financial statements for fiscal year 2013 to comply with the Chief Financial Officers Act of 1990, as amended. 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 CliftonLarsonAllen, LLP (CliftonLarsonAllen) to audit the financial statements of the Department as of September 30, 2013, and for the year then ended. The contract requires that the audit be performed in accordance with U.S. generally accepted government auditing standards and Office of Management and Budget bulletin, *Audit Requirements for Federal Financial Statements*.

Results of the Independent Audit

CliftonLarsonAllen found:

- The fiscal year 2013 financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America;
- Two significant deficiencies in internal control over financial reporting;
- No instances of reportable noncompliance with certain provisions of laws and regulations tested or other matters, except for noncompliance with the Federal financial management systems requirement of the Federal Financial Management Improvement Act of 1996.

Evaluation and Monitoring of Audit Performance

The Inspector General Act of 1978 requires that the Inspector General take appropriate steps to assure that any work performed by non-Federal auditors complies with the audit standards established by the Comptroller General. In that regard, we evaluated the independence, objectivity, and qualifications of the auditors and specialists; reviewed the plan and approach of the audit; monitored the performance of the audit; reviewed CliftonLarsonAllen's reports and related audit documentation; and inquired of its representatives.

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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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 or other matters.

CliftonLarsonAllen 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 or other matters. Our review disclosed no instances where CliftonLarsonAllen did not comply, in all material respects, with U.S. generally accepted government auditing standards.

We appreciate the cooperation given CliftonLarsonAllen and my office during the audit. If you have any questions or would like to discuss the reports, please contact me at (202) 245-6900.

Sincerely,



Kathleen S. Tighe
Inspector General

Enclosure

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



CliftonLarsonAllen LLP
www.cliftonlarsonallen.com

INDEPENDENT AUDITORS' REPORT

Inspector General
United States Department of Education

Secretary
United States Department of Education

In our audit of the fiscal year (FY) 2013 financial statements of the U.S. Department of Education (the Department), we found:

- The financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America (U.S.);
- Two significant deficiencies in internal control over financial reporting;
- No instances of reportable noncompliance with certain provisions of laws and regulations tested or other matters, except for noncompliance with the Federal financial management systems requirement of the Federal Financial Management Improvement Act of 1996 (FFMIA).

The following sections and Exhibits discuss in more detail: (1) these conclusions, (2) Management's Discussion and Analysis (MD&A), other required supplementary information (RSI), and other information included with the financial statements, (3) management's responsibilities, (4) our responsibilities, (5) management's response to findings and (6) the current status of prior year findings.

Report on the Financial Statements

We have audited the accompanying financial statements of the Department, which comprise the consolidated balance sheet as of September 30, 2013, and the related consolidated statements of net cost and changes in net position, the combined statement of budgetary resources for the year then ended, and the related notes to the financial statements. The objective of our audit was to express an opinion on the fairness of these financial statements.

Management's Responsibilities

Department management is responsible for the (1) preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the U.S., (2) preparation, measurement, and presentation of the RSI in accordance with the prescribed accounting principles generally accepted in the U.S., (3) preparation and presentation of other information in documents containing the audited financial statements and auditors' report, and consistency of that information with the audited financial statements and the RSI; and (4) design, implementation, and maintenance of internal control relevant to the preparation and fair

INDEPENDENT AUDITORS' REPORT (Continued)

presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibilities

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the U.S. and the standards applicable to the financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. We also conducted our audit in accordance with Office of Management and Budget (OMB) Bulletin No. 14-02, *Audit Requirements for Federal Financial Statements* (OMB Bulletin 14-02).

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion on the Financial Statements

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the U.S. Department of Education as of September 30, 2013, and its net costs, changes in net position, and budgetary resources for the year then ended, in accordance with accounting principles generally accepted in the U.S.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the U.S. require that the Department's MD&A and other RSI illustrated on pages 2 through 42 and 90 through 93, be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Federal Accounting Standards Advisory Board (FASAB), who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the MD&A and other RSI in accordance with auditing standards generally accepted in the U.S., 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 financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the MD&A or other RSI

INDEPENDENT AUDITORS' REPORT (Continued)

because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

The Message from the Secretary and the Other Information on pages ii through iv and 122 through 145 contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or RSI. The Message from the Secretary and the Other Information has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Prior Year Financial Statements

The FY2012 financial statements of the Department were audited by other auditors whose report, dated November 16, 2012, expressed an unmodified opinion on those statements.

Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

Report on Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Department's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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 or on management's assertion on internal control included in the MD&A. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control or on management's assertion on internal control included in the MD&A.

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, such that there is a reasonable possibility that a material misstatement of the Department's financial statements will not be prevented, or detected and corrected on a timely basis. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, we identified certain deficiencies in internal control, described below and in Exhibit A, that we consider to be significant deficiencies.

INDEPENDENT AUDITORS' REPORT (Continued)

Functionality and internal controls over some loan servicing systems need improvement

The Department's Federal Student Aid (FSA) office experienced significant issues with the initial functionality of two new loan servicing systems implemented at the beginning of FY2012. These issues directly impacted the reliability of borrower account information and the related financial statement balances throughout FY2012. Management identified, and the implemented corrective actions addressed, a number of the underlying system issues in FY2012. However, some of the remaining FY2012 issues, including new issues of lesser significance identified in FY2013, continued to impact the reliability of borrower account information and related financial statement balances throughout FY2013. The primary issues affecting the reliability of the Department's financial reporting during FY2013 included:

- Defaulted student loans, valued at \$1.1 billion, had not yet been transferred to the new defaulted loan servicing system due to system functionality and new servicer set up issues at September 30, 2013.
- The defaulted loan servicing system was unable to report transfer transactions to the general ledger reliably during the year, resulting in large transfer differences with both the general ledger and with the non-defaulted loan servicers.
- Additional errors affecting the interest rate and calculation of interest on defaulted loans were identified, affecting six million borrowers for an estimated \$79 million at September 30, 2013.
- Both new systems continued to experience financial reporting errors and delays in recording cash receipts during the year, resulting in ongoing differences with the U.S. Treasury reported balances.
- Both new systems continued to experience errors and delays in the reporting of the application of loan payments to the general ledger, resulting in aged unapplied cash balances.
- Unrecorded and erroneously recorded transactions in both new systems continued to affect the Department's ability to complete timely and accurate account reconciliations.
- Systemic issues in the non-defaulted loan servicing system affected the accuracy of borrower accounts and the general ledger.
- Programming errors related to the truncation of accrued interest on large non-defaulted loan balances were identified in FY2013, affecting 54 loans for an estimated \$9 million in unrecorded interest.

Correcting the impact of these issues on individual borrower accounts has been an intensive process, requiring the Department to 1) identify the cause for the error, 2) establish controls for preventing proliferation of the issues, 3) identify affected borrowers, 4) correct the system functionality for key business processes, 5) where applicable, correct the underlying data, and 6) recalculate the correct borrower loan balances. The affected borrowers, who represent a small portion of the Department's loan portfolio, will be (or have been) notified of adjustments to their balances as a result of this process. Corrective actions are further complicated by the Department transferring many of the affected accounts from the new systems to other loan servicers in FY2013. As of September 30,

INDEPENDENT AUDITORS' REPORT (Continued)

2013, the portfolio of the new non-defaulted loan system was transferred out to other servicers, effectively mitigating the risk of proliferation of issues.

Ensuring the effect of these system functionality issues is properly accounted for in the Department's internal and external financial reports has also required extensive resources dedicated to managing the complex reconciliation processes and the resolution of improperly posted transactions.

The Department and FSA management need to mitigate persistent Information Technology (IT) control deficiencies

Due to the unique requirements of the Department's grant, loan and administrative business activities, the Department oversees a large portfolio of government-owned/government operated, government-owned/contractor-operated, and contractor-owned/contractor-operated information systems. Five FSA systems and one Department system comprise the key financial systems. The third party servicers who manage the Department and FSA's general support systems are monitored by management through the use of Service Level Agreements and independent reviews. For several years, financial and other audits have identified numerous system deficiencies that affect the security and reliability of the information within these systems. Our audit continued to identify similar control deficiencies in the following areas:

Security management

- The Department's IT policies were outdated or did not fully address specific controls required by the National Institute of Standards and Technology (NIST)
- Incomplete System Security Plans
- Annual security control assessments not completed
- System risk assessments not kept up-to-date
- Lack of tracking and passed deadlines for corrective actions related to IT control weaknesses
- Security awareness training for new personnel not completed
- Role based security awareness training for personnel with significant system security responsibilities not completed

Personnel security

- Background reinvestigations not being tracked effectively

Access controls

- Lack of documented approval for system access
- Untimely termination of system access for separated employees and contractors
- Inactive accounts not disabled
- Inappropriate authorization for users with access to both development and production environments, resulting in a segregation of duties issue
- Duplicate user accounts
- Incomplete user recertification
- Expired or undocumented external interconnection security agreements

INDEPENDENT AUDITORS' REPORT (Continued)

Incident response

- Inaccurate tracking of security incidents

Configuration management

- System configuration settings not in compliance with Department policy

Contingency planning

- Contingency plan not kept up-to-date

Additionally, four of seven independent reviews of Federal Student Aid's (FSA) third party servicers identified the following IT control issues:

- Developer access to the production environment for one system
- Improper restriction and monitoring of privileged access
- Lack of adherence to configuration management plans
- Lack of contingency procedures, back up procedures, inadequate disaster recovery testing, and failure to maintain adequate offsite data backups
- Lack of an adequate organization-level risk assessment process
- Data management strategies not formally identified, documented, and authorized

These deficiencies can increase the risk of unauthorized access to the Department's systems used to capture, process, and report financial transactions and balances.

Report on Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's financial statements are free from 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. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests, exclusive of those required by FFMIA as discussed below, disclosed no instances of noncompliance or other matters that are required to be reported in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States or OMB Bulletin 14-02.

Systems Compliance with FFMIA Requirements

Under FFMIA, we are required to report whether the financial management systems used by the Department substantially comply with the (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Standard General Ledger (USSGL) at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements. However, providing an opinion on compliance with FFMIA was not an objective of our audit, and accordingly, we do not express such an opinion. As discussed below, the results of our tests disclosed the Department's financial management systems did not substantially comply with Federal financial management systems requirements. The results of our tests disclosed no instances where the Department's financial management systems did not substantially comply with applicable Federal accounting standards or the USSGL at the transaction level.

INDEPENDENT AUDITORS' REPORT (Continued)

The Department's financial management systems do not meet Federal financial management systems requirements

As noted in the two significant deficiencies summarized above, several of the Department's financial systems for managing the Department's portfolio of loans receivable possessed technical and operational deficiencies in their functionality and general and application controls that impacted the Department's ability to maintain effective internal control over operations and reliable financial reporting, and to produce reliable and timely information for managing the day-to-day operations of the Department throughout FY2013. These deficiencies also impacted the efficiency of the Department's operation for servicing the direct loan portfolio.

FSA's Office of Business Operations is responsible for ensuring the overall compliance of these systems with FFMIA requirements.

Additional detail on the nature of these deficiencies, their causes and our specific recommendations are presented in Exhibit A. Additional detail on this noncompliance is presented in Exhibit B.

Management's Responsibility for Internal Control and Compliance

Management is responsible for (1) evaluating the effectiveness of internal control over financial reporting based on criteria established under the Federal Managers Financial Integrity Act (FMFIA), (2) providing a statement of assurance on the overall effectiveness on internal control over financial reporting, (3) ensuring the Department's financial management systems are in substantial compliance with FFMIA requirements, and (4) ensuring compliance with other applicable laws and regulations.

Auditors' Responsibilities

We are responsible for: (1) obtaining a sufficient understanding of internal control over financial reporting to plan the audit, (2) testing whether the Department's financial management systems substantially comply with the FFMIA requirements referred to above, (3) testing compliance with certain provisions of laws and regulations that have a direct and material effect on the financial statements and applicable laws for which OMB Bulletin 14-02 requires testing, and (4) applying certain limited procedures with respect to the RSI and all other information included with the financial statements.

We did not evaluate all internal controls relevant to operating objectives as broadly established by the FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our audit results to future periods is subject to risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate. In addition, we caution that our internal control testing may not be sufficient for other purposes.

INDEPENDENT AUDITORS' REPORT (Continued)

We did not test compliance with all laws and regulations applicable to the Department. We limited our tests of compliance to certain provisions of laws and regulations that have a direct and material effect on the financial statements and those required by OMB Bulletin 14-02 that we deemed applicable to the Department's financial statements for the fiscal year ended September 30, 2013. We caution that noncompliance with laws and regulations may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. Also, our work on FFMIA would not necessarily disclose all instances of noncompliance with FFMIA requirements.

Management's Response to Findings

Management's response to the findings identified in our report is presented in Exhibit D. We did not audit the Department's response and, accordingly, we express no opinion on it.

Status of Prior Year's Control Deficiencies

We have reviewed the status of the Department's corrective actions with respect to the findings included in the prior year's *Report on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards*, dated November 16, 2012. The status of prior year findings is presented in Exhibit C.

Purpose of the Report on Internal Control over Financial Reporting and the Report on Compliance and Other Matters

The purpose of the Report on Internal Control over Financial Reporting and the Report on Compliance and Other Matters sections of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the Department's internal control or on compliance. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Department's internal control and compliance. Accordingly, these reports are not suitable for any other purpose.



CliftonLarsonAllen LLP
Arlington, Virginia
December 11, 2013

INDEPENDENT AUDITORS' REPORT
Exhibit A
Significant Deficiencies

Functionality and Internal Controls Over Some Loan Servicing Systems Need Improvement

In order to process the millions of transactions resulting from the rapidly growing portfolio of direct student loans, the Department has contracted with various loan servicers who record loan transactions, process collections, manage borrower accounts and borrower communications, report transactions to the Department's general ledger, and assist the Department in reconciling the general ledger to the various proprietary loan origination and servicing systems and platforms. In early FY2012, two new loan servicing systems, one exclusively dedicated to servicing defaulted student loans, were brought into production. Both systems contained various functionality issues, resulting in improper loan servicing, errors in account balances, and untimely financial reporting and account reconciliations. Although the most significant functionality issues were identified and addressed in FY2012, the Department continued to experience difficulties in resolving their effects throughout FY2013. In their efforts to implement corrective actions, the Department identified additional programming errors affecting borrower balances. The primary issues affecting the reliability of the Department's financial reporting during FY2013 included:

- Defaulted student loans, valued at \$1.1 billion, had not yet been transferred to the new defaulted loan servicing system due to system functionality and new servicer set up issues at September 30, 2013.
- The defaulted loan servicing system was unable to report transfer transactions to the general ledger reliably during the year, resulting in large transfer differences with both the general ledger and with the non-defaulted loan servicers.
- Additional errors affecting the interest rate and calculation of interest on defaulted loans were identified, affecting six million borrowers for an estimated \$79 million at September 30, 2013.
- Both new systems continued to experience financial reporting errors and delays in recording cash receipts during the year, resulting in ongoing differences with the U.S. Treasury reported balances.
- Both new systems continued to experience errors and delays in the recording of the application of loan payments to the general ledger, resulting in aged unapplied cash balances.
- Unrecorded and erroneously recorded transactions in both new systems continued to affect the Department's ability to complete timely and accurate account reconciliations.
- Systemic issues in the non-defaulted loan servicing system affected the accuracy of borrower accounts and the general ledger.
- Programming errors related to the truncation of accrued interest on large non-defaulted loan balances were identified in FY2013, affecting 54 loans for an estimated \$9 million in unrecorded interest.

These issues are discussed in detail on the following pages.

Transfer of defaulted loans to the new defaulted loan servicing system

Defaulted student loans were not transferred timely to the new defaulted loan servicing system, the Debt Management and Collection System (DMCS), due to system functionality and new servicer set up issues. DMCS continued to experience difficulty in processing redefaulted loans

INDEPENDENT AUDITORS' REPORT
Exhibit A
Significant Deficiencies

where the initial default was processed in the legacy system, since the legacy data on the initial default was not transferred over from the legacy system into DMCS. Late in FY2013, the major functionality issues preventing the transfer of redefaulted loans to DMCS were resolved. This allowed redefaulted loans for 54,000 borrowers, valued at \$752 million, to be successfully transferred to DMCS during FY2013. However, there remained a redefaulted loan backlog at September 30, 2013 consisting of 66,824 borrowers with loan balances of \$941 million. Working with the defaulted loan servicer, management has developed a plan that is expected to complete the transfer and clear the backlog of redefaulted loans by the end of May 2014. Further, new not-for-profit loan servicers established in FY2013 were not immediately set up to transfer defaulted loans to the new defaulted loan servicing system.

As a result of the system functionality and the new servicer set up issues, loans beyond 365 days of delinquency, valued at \$1.1 billion, have not yet been transferred to DMCS at September 30, 2013.

While the balance of these defaulted loans was properly reported in the accompanying financial statements, the servicers holding these loans did not initiate defaulted loan servicing activities during this time. It is not clear what impact, if any, this delay will have on the collectability of these loans.

Timely recording of the defaulted loan transfer transactions to the general ledger

The defaulted loan servicing system was unable to record transfer transactions to the general ledger timely during the year, resulting in large differences in the net balance of transfers with the general ledger and the non-defaulted loan servicers. In reviewing the portfolio reconciliations between DMCS and the general ledger for direct loans, we noted differences greater than \$2.5 billion in principal and \$300 million in interest throughout the first quarter arising from the system's failure to report changes in DMCS to the monthly financial activity transactions file transmitted to the general ledger. This system functionality issue was largely corrected in March 2013, at which time the difference decreased to \$72 million in principal and \$108 million in interest. At June 30 and September 30, 2013, these differences amounted to \$25 million in principal and \$15 million in interest.

We also noted large variances in the portfolio reconciliations between DMCS and the general ledger for defaulted and acquired FFEL loans, which were reduced to much smaller differences at September 30, 2013.

The Department's reconciliation procedures identified approximately \$69 million in transfer-out related transaction correction entries that were incorrectly coded as write-offs in DMCS. These were subsequently recoded as transfers in DMCS. Approximately \$712 million of transfer out transactions did not pass the general ledger system edit check process. A multi-step correction process was then performed for these transactions to be correctly processed in the general ledger as transfers out of DMCS.

Despite the progressive reduction of the overall difference between the DMCS transactions reported in the monthly financial activity files that were transmitted to the general ledger, loan transfers in and out of DMCS continue to not be recorded timely. At September 30, 2013, management reported that there was a difference of \$137 million between the defaulted loan transfers to DMCS reported by other servicers and the amounts reported by DMCS to the general ledger. Further, at September 30, 2013, DMCS had transferred \$296 million in

INDEPENDENT AUDITORS' REPORT
Exhibit A
Significant Deficiencies

rehabilitated loans to other servicers for which the receiving servicer had not recorded the transfer-in entry to the general ledger. These differences represent servicer level differences and do not impact the accuracy of the loan receivable balances reported in the accompanying financial statements.

Errors affecting the interest rate and calculation of interest on defaulted loans

During their efforts to correct the DMCS system functionality issues, the Department and its defaulted loan servicer identified additional interest rate conversion and coding errors in FY2013 that affected six million borrower accounts with an estimated gross adjustment to the loan principal and the related accrued interest balance of \$79 million. The corrective actions related to this issue are complicated by rehabilitated defaulted loans that have since been transferred to other servicers and defaulted loans that have since been discharged, paid-in-full or compromised. While several interest rate corrections have been completed in FY2013, the execution of the remaining corrections is expected to take place in FY2014.

Errors and delays in recording cash receipts during the year resulted in differences with the U.S. Treasury reporting for both new systems

Borrower payments are sent to a Federal lockbox, where data on batches of deposits and other cash transactions, referred to as "schedules", are transmitted to both the servicers' systems and the U.S. Treasury's Collections Information Repository (CIR). The Department requires servicers to record the schedules in the servicing system within one to two business days and then transmit the information electronically to the Department's general ledger. Due to functionality issues with the two new systems, a large number of schedules were rejected from recording in the general ledger upon initial transmittal. Every time a transaction transmission was rejected from posting, the servicers had to correct and resubmit the erroneous transactions. However, the delay in recording transactions gave rise to differences between the Department's general ledger balances and the balances reported by the U.S. Treasury. The transactions recorded in the U.S. Treasury's CIR but not recorded in the Department's general ledger totaled approximately \$164 million, \$231 million, \$138 million, and \$6 million at December 30, 2012, March 31, 2013, August 31, 2013 and September 30, 2013, respectively. The decrease in reporting differences at the end of the fiscal year reflects the significant completion of the corrective actions implemented during the year, which were closely monitored by Department management.

Errors and delays during the year resulted in aged balances of unapplied loan payments for both new systems

Schedules of cash transactions received from the Federal lockbox are initially recorded in a suspense fund. The Department's loan servicers also receive electronic data on all borrower collections that comprise the cash transaction schedule. Payments should be applied to the borrower's account within 24 hours of receipt. When loan servicers apply payments to borrowers' accounts, the corresponding amount is removed from the suspense fund and transferred to the appropriate fund (e.g., direct loan, FFEL, etc.). The payment application transactions recorded in the servicer system are sent electronically for recording in the Department's general ledger. Both new servicing systems continued to experience financial reporting errors and delays during the year, resulting in aged suspense fund balances older and larger than Department targets. As a result of close monitoring action, much of the suspense account issues identified during the year were addressed at year end. The balance of transactions in suspense at September 30, 2013 for both new systems was a negative \$62 million, with approximately \$44 million or 71% of the balance greater than 60 days old. The

INDEPENDENT AUDITORS' REPORT
Exhibit A
Significant Deficiencies

negative suspense account balance was caused by recorded cash applications greater than recorded deposits. As discussed in the preceding paragraph, some initial suspense deposit transactions failed posting edits, whereas the subsequent cash application transactions to the borrowers' accounts were posted timely.

Unrecorded and erroneously recorded transactions in both new systems continued to affect the Department's ability to complete timely and accurate account reconciliations

Each loan servicer is required to submit daily files of summarized activity to the general ledger. Throughout the year, management reported that both servicer systems had a large number of other transactions that had failed the general ledger edits and posted to an error file. Management reported that, at June 30, the defaulted loan management system had 485,000 transactions on the general ledger error file. At August 31 and September 30, 2013, 253,000 and 66,000 transactions, respectively, were in the error file. Given the large number of transactions not properly posted, there were numerous reconciling items between the loans receivable and accrued interest balances in the general ledger and the balances in the new systems. This impacted the servicer's ability to prepare, review and submit monthly reconciliations to the Department timely through all of FY2013. In addition, many reconciliations also contained reconciling differences that were outstanding over 30 days. Reconciling differences at September 30, 2013 for the two new systems totaled approximately \$142 million.

Systemic issues in the non-defaulted loan servicing system affected the accuracy of borrower accounts and the general ledger

During their monitoring of the new non-defaulted loan servicing system, ACS, Inc. Education Servicing System (ACES), Department management continued to identify systemic issues related to transaction processing. For example, the Department's reconciliation procedures identified approximately \$31 million of transactions, primarily transfer transactions, that were incorrectly recorded in the general ledger as write offs, although they were not processed in ACES as write-offs.

Our sample testing revealed multiple processing actions applied in the servicing system to write-off transactions, increasing the risk of misstatement. Further, during our testing of the loan portfolio, we identified some loans that were affected by the prior year system configuration issues that failed to capitalize interest accrued over certain deferment and forbearance periods. Management estimates this issue resulted in lost interest of approximately \$55 million since July 2012.

As part of its corrective action plans, management processed a significant number of corrections in the current year, amounting to more than \$110 million. However, management identified additional adjustments in the amount of \$157 million that continued to affect the loan portfolio at September 30, which are expected to be corrected in the following fiscal year.

All of the issues discussed above can be directly related to the effect of not properly testing a new information system before putting the system into production. In order to mitigate risks going forward, management has elected to let the contract for ACES expire and has transferred the ACES loan portfolio to other servicers, which have been tasked with correcting the misstated loan balances. Management has also awarded a new contract for the management of the DMCS system application in future years. Management and its contractors have dedicated significant resources to identify, track, and correct the system functionality and the

INDEPENDENT AUDITORS' REPORT
Exhibit A
Significant Deficiencies

corresponding data; quantify the impact of the errors; and ensure that the financial statements properly reflect the effect of these issues. Other servicer issues noted during our audit included:

Programming errors related to the truncation of accrued interest on large non-defaulted loan balances were identified

Some non-defaulted loan servicing systems were affected by programming errors that caused them to truncate any daily interest amounts in excess of \$99.99, resulting in the underaccrual of interest on very large loan balances. Management estimates this issue only affects 54 loans, with an estimated effect of \$9 million of unrecorded interest. While the additional interest accrual will be significant for the affected borrowers, we determined that the amount was not material to the financial statements.

Recommendations:

We recommend the Chief Operating Officer of FSA:

- 1a. Ensure all servicing application functionality is corrected to meet the Department's requirements for servicing loans and reporting financial activity and balances timely and accurately.
- 1b. Continue to monitor the scheduled transfers of defaulted loans to DMCS and ensure that all new loan servicers are fully set up to transfer defaulted loans to the defaulted loan servicer.
- 1c. Continue to correct loan balances affected by the functionality issues and properly inform the impacted borrowers of the corrected account balances.
- 1d. Continue to monitor servicers' efforts to reduce the balance of unposted cash transactions, unrecorded borrower transactions, and general ledger posting differences, including the posting of transfer transactions in and out of DMCS.
- 1e. Establish protocols for management approval for write-offs and manual adjustments of unresolved differences once corrective actions are no longer cost effective.
- 1f. Continue to monitor the timeliness and accuracy of account reconciliations prepared by the servicers.

2. Department and FSA Management Need to Mitigate Persistent Information Technology (IT) Control Deficiencies

Due to the unique requirements of the Department's grant, loan and administrative business activities, the Department oversees a large portfolio of government-owned/government operated, government-owned/ contractor-operated, and contractor-owned/contractor-operated information systems. Five FSA systems and one Department system comprise the key systems critical to the Department's financial statement reporting.

The third party service providers who manage the Department and FSA's general support systems and applications are monitored by management through the use of Service Level

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Significant Deficiencies

Agreements and independent reviews. Managing the information and system security across the Department is the responsibility of the Department's Chief Information Security Officer (CISO), in conjunction with FSA's CISO. For several years, financial and other audits have identified numerous system deficiencies that affect the security and reliability of the information within these systems. Our audit continued to identify similar control deficiencies in the following areas:

Security management

- The Department's IT policies were outdated or did not fully address specific controls required by the National Institute of Standards and Technology (NIST)
- Incomplete System Security Plans
- Annual security control assessments not completed
- System risk assessments not kept up-to-date
- Lack of tracking and passed deadlines for corrective actions related to IT control weaknesses
- Security awareness training for new personnel not completed
- Role based security awareness training for personnel with significant system security responsibilities not completed

Personnel Security

- Background reinvestigations not being tracked effectively

Access Controls

- Lack of documented approval for system access
- Untimely termination of system access for separated employees and contractors
- Inactive accounts not disabled
- Inappropriate authorization for users with access to both development and production environments, resulting in a segregation of duties issue
- Duplicate user accounts
- Incomplete user recertification
- Expired or undocumented external interconnection security agreements

Incident Response

- Inaccurate tracking of security incidents

Configuration management

- System configuration settings not in compliance with Department policy

Contingency Planning

- Contingency plan not kept up-to-date

Additionally, four of the seven independent reviews of FSA third party service providers identified the following IT control issues:

- Developer access to the production environment of one system
- Improper restriction and monitoring of privileged access
- Lack of adherence to configuration management plans

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Significant Deficiencies

- Lack of contingency procedures, back up procedures, inadequate disaster recovery testing, and failure to maintain adequate offsite data backups
- Lack of an adequate organizational-level risk assessment process
- Data management strategies not formally identified, documented, and authorized

These deficiencies can increase the risk of unauthorized access to the Department's systems used to capture, process, and report financial transactions and balances. These findings are discussed in further detail below and in a Limited Distribution Report provided to the Department and FSA management.

Security management

An effective information security management program should have a framework and process for assessing risk, effective security procedures, and processes for monitoring and reporting the effectiveness of these procedures.

We found the Department's IT policies were outdated or did not fully address specific controls required by NIST Special Publication (SP) 800-53 (revision 3), *Recommended Security Controls for Federal Information Systems and Organizations*.¹ Additionally we found deficiencies in the system security plans (SSP) for three systems.

Furthermore, an annual self assessment was not performed for three of the six systems tested. Since a self assessment was not performed for these systems the risk assessments were not updated resulting in an increased risk that the CISO, ISSO, and system owners were not informed of the ongoing security state and risks to these systems. Upon notification of this issue to management, the self assessments were performed; however, the assessments included only a test of the design of controls, not testing to validate controls were operating effectively. In addition, although a controls assessment was performed for the other three systems tested, we noted several control tests were incomplete for one of three systems.

With regard to corrective action of IT control weaknesses, we noted there were 325 individual Plans of Action and Milestones (POA&M) that had passed their 2013 scheduled dates of completion for one system without documented justification for missed completion dates or adjusted expected completion dates. We also noted that corrective action of certain control weaknesses for another system was not formally tracked. Without formally documenting the weaknesses, along with the mitigation plans, estimated dates of completion and status of

¹ NIST SP 800-53 revision 4 was issued in April 2013. According to the Office of Management and Budget (OMB) memorandum M-10-15, *FY 2010 Reporting Instructions for the Federal Information Security Management Act and Agency Privacy Management* requires that for non-national security programs and information systems, agencies must follow NIST standards and guidelines. For legacy information systems, agencies are expected to be in compliance with NIST standards and guidelines within one year of the publication date unless otherwise directed by OMB. The one year compliance date for revisions to NIST publications applies only to the new and/or updated material in the publications.

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corrective actions, there is no formal process in place to track and ensure the weaknesses are remediated.

Finally, we noted three sampled new system users did not complete the required security awareness training for two of the systems tested. Also, individuals with significant system security responsibilities had not completed role based training in the past two years for one system tested.

Personnel Security

Personnel security involves screening individuals before granting them access to computer resources commensurate with the risk and magnitude of the harm the individual could cause. We found background reinvestigations not being tracked effectively, as a sampled individual with significant system security responsibilities had an overdue reinvestigation. Management initiated this investigation upon our notification.

Access Controls

Access controls limit or detect inappropriate access to systems, protecting the data within them from unauthorized modification, loss or disclosure. Agencies should have formal policies and procedures and related control activities should be properly implemented and monitored. One key element of access control is *boundary protection*. Properly managed interfaces between the Department and FSA systems and external parties help reduce the risk of unauthorized access. NIST SP 800-47, *Security Guide for Interconnecting Information Technology Systems*, specifies that an agreement should be documented for the interconnection between organizations. A Memorandum of Understanding (MOU) documents the terms and conditions for sharing data and information resources in a secure method. An Interconnection Security Agreement (ISA) identifies the technical and security requirements for establishing, operating, and maintaining the interconnection and supports the MOU. We found expired MOUs and instances in which no documented MOU or ISA existed for external interconnections for four of the six systems tested.

User authorization refers to the documentation of the granting of user access to only the elements of a system the user needs to perform his or her duties. To be an effective control, user access should be documented, approved and periodically reviewed. Accounts for users should be terminated when the user no longer needs access to the system. We found:

- Access approval for system users was not documented for two of the systems tested
- Accounts for terminated employees and contractors were not disabled for two of the systems tested
- Inactive accounts were not disabled for one system
- One system had duplicate accounts
- User access recertification was incomplete for three of the systems tested
- Users with access to both the development and production environments for one system tested, resulting in a segregation of duties issue

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Incident Response

Incident response includes the identification and tracking of system events, analysis, and investigation of the events and implementation of corrective action. We noted inaccurate tracking of incidents by the Department.

Configuration Management

Configuration management ensures changes to systems are approved and systems are configured securely in accordance with policy. In our audit, we found four systems with configuration settings that were not in compliance with Department policy. For a fifth system, although management communicated a business need for non compliance with policy, a Risk Acceptance Form was not documented as required by Department policy.

Contingency Planning

Contingency planning is key to ensuring continuity of operations should system disruption occur. Of the six systems tested, we found one of the contingency plans was not up-to-date.

We noted the FY 2013 FSA FMFIA Assurance Letter reported similar IT control deficiencies. Additionally, the FY 2013 Federal Information Security Management Act (FISMA) review identified the following issues in seven of the eleven reporting metrics: configuration management, identity and access management, incident response and reporting, risk management, security training, remote access management, and contingency planning. The findings in the seven reporting metrics included repeat or modified repeat findings from audit reports issued over the last three years.

These deficiencies can increase the risk of unauthorized access to the Department's systems used to capture, process, and report financial transactions and balances.

NIST Special Publication 800-39, *Managing Information Security Risk - Organization, Mission, and Information System View*, states:

The complex relationships among missions, mission/business processes, and the information systems supporting those missions/processes require an integrated, organization-wide view for managing risk. Unless otherwise stated, references to risk in this publication refer to information security risk from the operation and use of organizational information systems including the processes, procedures, and structures within organizations that influence or affect the design, development, implementation, and ongoing operation of those systems. The role of information security in managing risk from the operation and use of information systems is also critical to the success of organizations in achieving their strategic goals and objectives. Historically, senior leaders/executives have had a very narrow view of information security either as a technical matter or in a stovepipe that was independent of organizational risk and the traditional management and life cycle processes. This extremely limited perspective often resulted in inadequate consideration of how information security risk, like other organizational risks, affects the likelihood of organizations successfully carrying out their missions and business functions. This publication places information security into the

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broader organizational context of achieving mission/business success. The objective is to:

- *Ensure that senior leaders/executives recognize the importance of managing information security risk and establish appropriate governance structures for managing such risk;*
- *Ensure that the organization's risk management process is being effectively conducted across the three tiers of organization, mission/business processes, and information systems;*
- *Foster an organizational climate where information security risk is considered within the context of the design of mission/business processes, the definition of an overarching enterprise architecture, and system development life cycle processes; and*
- *Help individuals with responsibilities for information system implementation or operation better understand how information security risk associated with their systems translates into organization-wide risk that may ultimately affect the mission/business success.*

To successfully execute organizational missions and business functions with information system-dependent processes, senior leaders/executives must be committed to making risk management a fundamental mission/business requirement. This top-level, executive commitment ensures that sufficient resources are available to develop and implement effective, organization-wide risk management programs. Understanding and addressing risk is a strategic capability and an enabler of missions and business functions across organizations. Effectively managing information security risk organization-wide requires the following key elements:

- *Assignment of risk management responsibilities to senior leaders/executives;*
- *Ongoing recognition and understanding by senior leaders/executives of the information security risks to organizational operations and assets, individuals, other organizations, and the Nation arising from the operation and use of information systems;*
- *Establishing the organizational tolerance for risk and communicating the risk tolerance throughout the organization including guidance on how risk tolerance impacts ongoing decision-making activities; and*
- *Accountability by senior leaders/executives for their risk management decisions and for the implementation of effective, organization-wide risk management programs.*

The ineffective and untimely remediation of application control weaknesses and repeat deficiencies identified across multiple applications indicates the need for improved strategic IT management.

In recognition of the need to improve internal control related to information security, in the latter part of FY2012, the Department and FSA senior management brought on board CISOs at the Senior Executive level with the skill set, broad government experience and leadership qualities to transform the information security program into a more robust, risk management program. During the past year, the Department and FSA Chief Information Security Officers have worked together to put a framework in place for more effectively managing risk by reviewing control weaknesses across the organization, determining root cause, and tracking remediation

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Exhibit A
Significant Deficiencies

activities. The security posture of the systems is reviewed on a monthly basis by reviewing control weaknesses noted from audits, self assessments, vulnerability scans, and associated POA&Ms. As part of this initiative, monthly meetings are conducted with the Information System Security Officers in which training related to remediation of controls issues is provided. In addition, the Department documented, and is in the process of implementing, a risk management framework for applying continuous monitoring based on NIST SP 800-37, *Guide for Applying the Risk Management Framework to Federal Information Systems*. Furthermore, FSA has funded a security operations center for centralizing the management of security issues. These activities show progress and commitment from the Department and FSA's senior managers to strengthening internal controls. The risk management improvement process initiated by the Department and FSA's CISOs has the potential to provide such strategic IT management.

Recommendations:

We recommend the Department and FSA CISOs:

- 2a. Refine and fully implement the program to monitor compliance with the Department's organization-wide information security program and NIST requirements at the Department and system level.
- 2b. Implement a process ensuring accountability for individuals responsible for remediating the identified control deficiencies in the Department and FSA's systems, including cooperation between the Technology Office and Business Operations.
- 2c. Implement a process for holding contractors accountable for remediation of control deficiencies in the Department and FSA systems.
- 2d. Implement a process for holding third party service providers accountable for the remediation of control deficiencies associated with their information systems.

INDEPENDENT AUDITORS' REPORT
Exhibit B
Noncompliance with Laws and Regulations

1. The Department's Financial Management Systems Do Not Meet Federal Financial Management System Requirements

OMB Circular No. A-123, *Management's Responsibility for Internal Control*, states "*internal control needs to be in place over information systems – general and application control. General control applies to all information systems such as the mainframe, network and end-user environments, and included agency-wide security program planning, management, control over data center operations, system software acquisition and maintenance.*"

OMB Circular No. A-127, *Financial Management Systems*, defines a financial system as "*an information system that may perform all financial functions including general ledger management, funds management, payment management, receivable management, and cost management.*" OMB Circular No. A-127 also notes a financial management system "*includes the core financial management systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, and controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.*"

OMB Circular No. A-127 continues, "*Substantial compliance is achieved when an agency's financial management systems routinely provide reliable and timely financial information for managing day-to-day operations as well as to produce reliable financial statements, maintain effective internal control, and comply with legal and regulatory requirements.*"

As noted in the two significant deficiencies in Exhibit A, several of the Department's financial systems and their general and application controls for managing the Department's portfolio of loans receivable possessed technical and operational deficiencies that impacted the Department's ability to maintain effective internal control over operations and financial reporting, and routinely produce reliable, timely and accurate information for managing the day-to-day operations of the Department throughout FY2013. These deficiencies also impacted the effectiveness and efficiency of the Department's operation for servicing the direct loan portfolio. Additional detail on the nature of these deficiencies, their causes and our specific recommendations are presented in Exhibit A.

INDEPENDENT AUDITORS' REPORT
Exhibit C
Status of Prior Year Recommendations

Our assessment of the current status of the recommendations related to findings identified in the prior year audit is presented below:

<i>FY 2012 Recommendation</i>	<i>Fiscal Year 2013 Status</i>
Material Weakness 1 – Controls Surrounding the Department's Debt Management Collection System and ACS, Inc. Education Servicing System Need Improvement	
1. Ensure that the DMCS servicer resolves and completes the remaining requirements in order to bring DMCS to a fully operational status. In the interim, establish temporary work-around solution for the remaining requirements, where applicable.	In process; see Significant Deficiency 1
2. Complete system fixes to resolve the issues surrounding interest accruals (DMCS) 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.	In process; see Significant Deficiency 1
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.	Closed
4. Require conformance and effectiveness of the previously noted controls and coordinate closely with the servicer to closely manage progress, status and corrective actions.	In process, see Significant Deficiency 1
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.	In process; see Significant Deficiency 2
Significant Deficiency 1 – Continued Focus on Credit Reform Estimates and Financial Reporting Processes is Warranted	
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.	In process; management letter comment
2. Increase the frequency of the Credit Reform Working Group meetings and take full advantage of their analytical reports to have robust discussions about loan activity and the impact of estimates with different area managers.	In process; management letter comment
3. Implement formal detail review procedures over the input of variables into the Student Loan Model, input of cash flows into the OMB calculator and other calculations surrounding the process to avoid potential errors that may negatively affect the	In process; management letter comment

INDEPENDENT AUDITORS' REPORT
Exhibit C
Status of Prior Year Recommendations

<i>FY 2012 Recommendation</i>	<i>Fiscal Year 2013 Status</i>
reestimates. 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. 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. Consider developing calibrating processes to ensure data quality and model accuracy.	In process; management letter comment
5. Consider the impact of changes in general economic conditions when developing assumptions. Evaluate the selection of time periods used for weighting average calculations on a periodic basis as economic conditions change.	In process; management letter comment
6. Consider ways to better leverage management's efforts under OMB Circular A-123, Appendix A as a way to provide additional focus and attention to the controls surrounding the credit reform estimation process.	In process; management letter comment
Significant Deficiency 2 – Controls Surrounding Information Systems Need Enhancement	
1. Strengthen access controls to protect mission critical systems.	In process; see Significant Deficiency 2
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.	In process; see Significant Deficiency 2
3. Enhance its security training and awareness program.	In process; see Significant Deficiency 2
4. Revise current methods of identifying and logging suspicious activity as it relates to unauthorized accounts and data.	In process; see Significant Deficiency 2

INDEPENDENT AUDITORS' REPORT
Exhibit C
Status of Prior Year Recommendations

<i>FY 2012 Recommendation</i>	<i>Fiscal Year 2013 Status</i>
5. Improve incidence response and reporting procedures.	In process; see Significant Deficiency 2
6. Improve contract management and oversight of contractors on mission critical systems.	In process; see Significant Deficiency 2
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 PO&AM system and reports.	In process; see Significant Deficiency 2

INDEPENDENT AUDITORS' REPORT
Exhibit D
Management's Response to Findings



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

THE CHIEF FINANCIAL OFFICER

DEC - 3 2013

MEMORANDUM

TO: Kathleen S. Tighe
Inspector General

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

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

SUBJECT: DRAFT AUDIT REPORTS
Financial Statement Audits for Fiscal Year 2013
U.S. Department of Education
ED-OIG/A17N0001

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 Year 2013 Financial Statement Audit Report. Without exception, we concur and agree with the Independent Auditors' Report.

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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