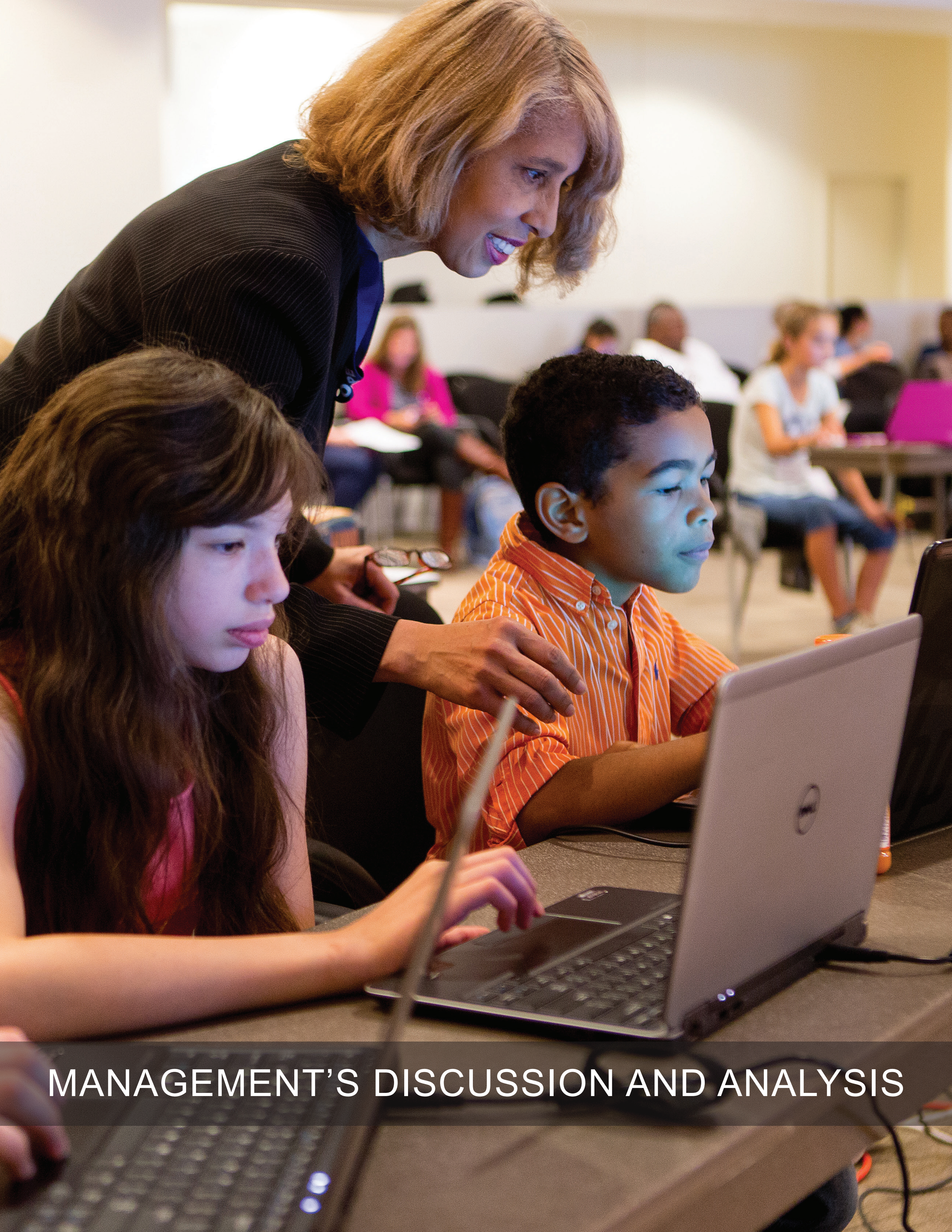


MANAGEMENT’S DISCUSSION AND ANALYSIS

ABOUT THE MANAGEMENT'S DISCUSSION AND ANALYSIS

The U.S. Department of Education (the Department) continued to enhance the content quality, report layout, and public accessibility of the Fiscal Year (FY) 2017 Agency Financial Report (AFR) by providing additional graphics and more useful, balanced, and easily understood information about the Department's grant and loan programs, including additional cost and risk information. Additionally, we augmented information provided in the body of the AFR with relevant web content to provide users with additional information about the Department's operations and performance. To take advantage of the hyperlinks embedded in the report, the Department recommends reading it **on the Internet**. To help us continue to improve the quality and usefulness of information provided in our AFR, we encourage our public and other stakeholders to provide feedback and suggestions at **AFRComments@ed.gov**.

This section highlights information on the Department's performance, financial statements, systems and controls, compliance with laws and regulations, and actions taken or planned to address select challenges.

MISSION AND ORGANIZATIONAL STRUCTURE

This section provides information about the Department's mission, an overview of its history, and its structure. The active links include the organization chart and principal offices and a link to the full list of **Department offices** with a description of selected offices by function.

DISCUSSION OF PERFORMANCE

This section includes an overview of performance reporting and a high-level discussion on the Department's focus areas for FY 2017. The results achieved from Department expenditures are discussed at a high level in the AFR. For more details about performance, please refer to the Department's budget and performance web page and **performance.gov**.

To view information on all Department programs, visit the **Department's website**.

FORWARD-LOOKING INFORMATION

The Forward-Looking Information section describes the challenges that the Department aims to address to achieve progress on Direct Loans, Shared Services, and Enterprise Risk Management (ERM).

FINANCIAL HIGHLIGHTS

The Department expends a substantial portion of its budgetary resources and cash on multiple loan and grant programs intended to support state and local efforts to improve learning outcomes for all prekindergarten through 12th grade (P–12) students in every community and to expand postsecondary education options and improve outcomes to foster economic opportunity and informed, thoughtful, and productive citizens. Accordingly, the Department included more high-level details about sources and uses of the federal funds received and net costs by program.

ANALYSIS OF SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

The Department's internal control framework and its assessment of controls, in accordance with Office of Management and Budget (OMB) **Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control***, provide assurance to Department leadership and external stakeholders that financial data produced by the Department's business and financial processes and systems are complete, accurate, and reliable.

ABOUT THE DEPARTMENT

OUR MISSION

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

Who We Are. In 1867, the federal government recognized that furthering education was a national priority and created a federal education agency to collect and report statistical data. The Department was established as a cabinet-level agency in 1980. Today, the Department supports programs in every area and level of education from preschool through postdoctoral research.

The **Department** makes funds and information available to individuals pursuing education, colleges and universities, state education agencies, and school districts by engaging in four major types of activities:

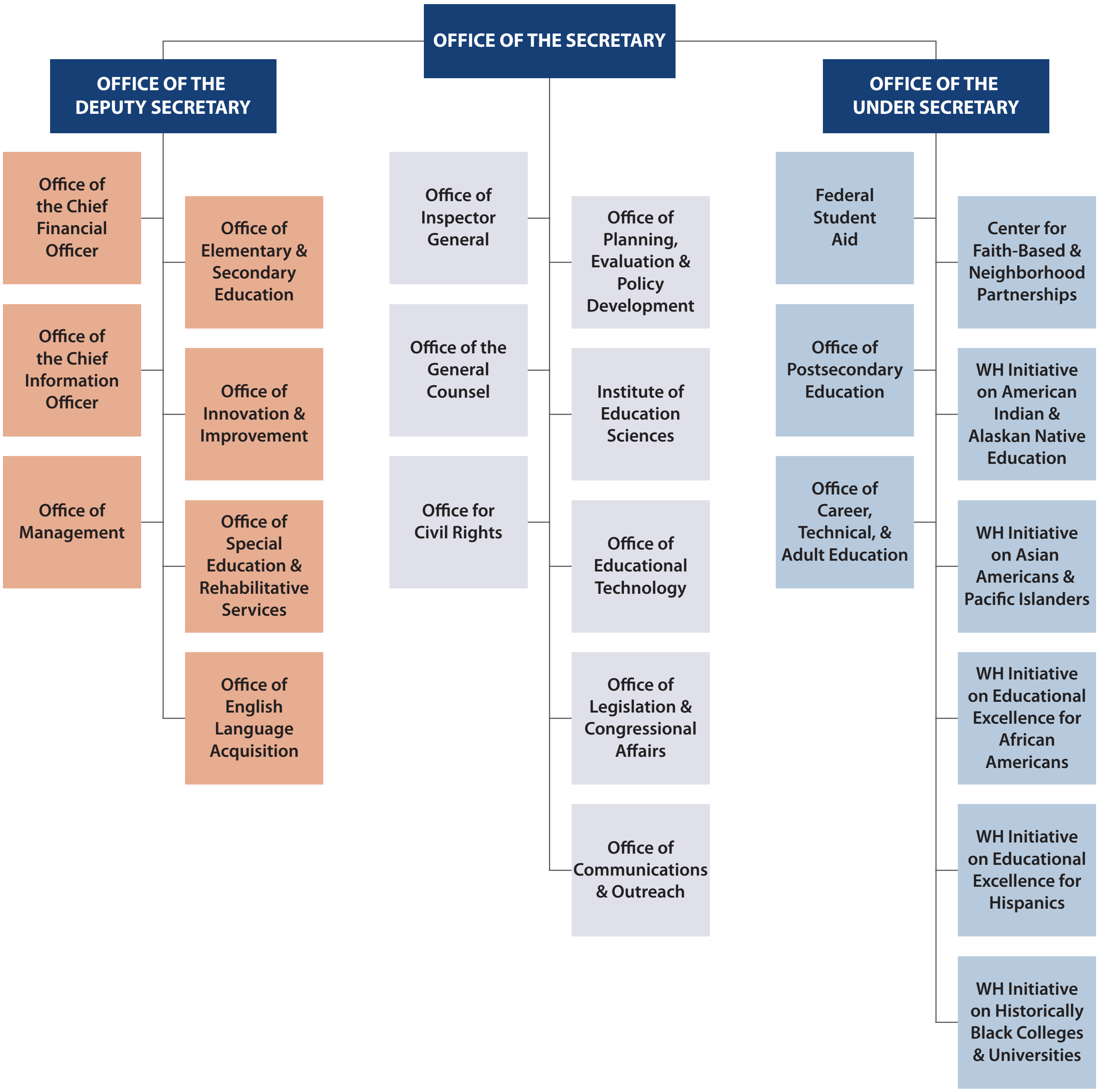
- establishing policies related to federal education funding, including distributing funds, collecting on student loans, and using data to monitor the use of funds;
- supporting data collection and research on America's schools;
- identifying major issues in education and focusing national attention on them; and
- enforcing federal laws promoting equal access and prohibiting discrimination in programs that receive federal funds.

Our Public Benefit. The Department executes the laws passed by Congress to promote student academic achievement and preparation for global competitiveness. The Department works with students, parents, educational institutions, school districts, and states to foster educational excellence and to ensure equal access to a high quality education for all students. While recognizing the primary role of states and school districts in providing high quality education, the Department is committed to helping ensure students throughout the nation develop skills to succeed in school, pursue postsecondary options, and transition to the workforce. The Department's vision is to improve educational outcomes for all students.

Many of the Department's programs involve awarding grants to state and local educational agencies and providing grants and loans to postsecondary students. The Department's largest outlays are for its portfolio of student loans (see the **Financial Highlights** and **Notes** sections). Grant programs constitute the second-largest driver of outlays. The grant programs include: student aid to help pay for college through Pell Grants, Work Study, and other campus-based programs; grants awarded based on statutory formulas mostly for elementary and secondary education (see the chart on page 5); and competitive grant programs to promote innovation (see **The Department's Approach to Performance Management** section). The Department also supports research, collects education statistics, and enforces civil rights statutes. We manage and spend financial resources on programs designed to support parents, teachers, principals, school leadership, institutions, and states in the pursuit of instilling knowledge and transferring skills to students.

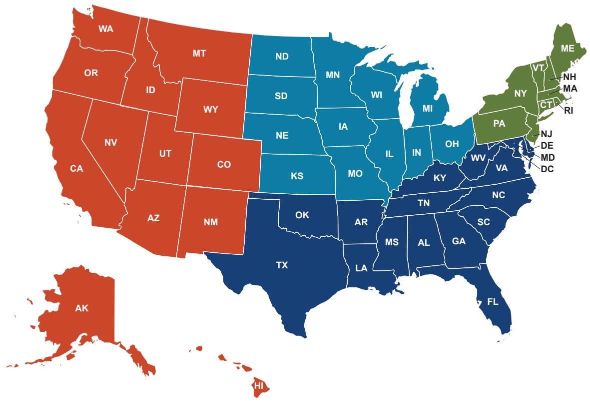
OUR ORGANIZATION IN FISCAL YEAR 2017

This chart reflects the coordinating structure of the U.S. Department of Education. **Interactive** and **text versions** of the FY 2017 coordinating structure of the Department are available.



FY 2016 ACTUAL FORMULA GRANT DISTRIBUTION BY REGION AND STATE

The figures in these tables are made up of funding from multiple programs allocated to states based on statutory formulas. These do not include discretionary grants, need-based grants, or federal loans. For more details, view the **Department's State Budget Tables**.



West	Grades K–12	Postsec	All Other
Alaska	$ 258	$ 36	$ 12
Arizona	829	1,044	100
California	4,058	3,791	404
Colorado	440	418	51
Hawaii	165	75	16
Idaho	163	162	21
Montana	170	67	16
Nevada	253	133	24
New Mexico	348	181	30
Oregon	372	342	58
Utah	272	378	34
Washington	662	429	68
Wyoming	112	29	11
TOTAL	**$ 8,103**	**$ 7,086**	**$ 844**

South	Grades K–12	Postsec	All Other
Alabama	$ 538	$ 496	$ 74
Arkansas	352	268	53
Delaware	116	60	15
District of Columbia	93	132	18
Florida	1,865	1,807	227
Georgia	1,111	942	111
Kentucky	495	379	65
Louisiana	627	383	47
Maryland	535	378	53
Mississippi	401	325	52
North Carolina	986	803	129
Oklahoma	457	295	45
South Carolina	525	379	68
Tennessee	678	529	73
Texas	3,217	2,166	308
Virginia	725	668	92
West Virginia	217	206	37
TOTAL	**$ 12,936**	**$ 10,217**	**$ 1,469**

NOTES: Dollars in millions. Detail may not add to totals due to rounding. Data are current as of September 13, 2017.

Midwest	Grades K–12	Postsec	All Other
Illinois	$ 1,488	$ 1,140	$ 137
Indiana	660	724	71
Iowa	285	374	35
Kansas	332	237	28
Michigan	1,149	829	124
Minnesota	483	461	59
Missouri	620	532	78
Nebraska	212	132	24
North Dakota	120	46	12
Ohio	1,275	793	129
South Dakota	164	86	12
Wisconsin	564	390	73
TOTAL	**$ 7,352**	**$ 5,744**	**$ 782**

Northeast	Grades K–12	Postsec	All Other
Connecticut	$ 330	$ 266	$ 33
Maine	148	107	19
Massachusetts	656	518	71
New Hampshire	128	117	13
New Jersey	898	617	80
New York	2,478	1,923	204
Pennsylvania	1,280	937	166
Rhode Island	131	108	16
Vermont	95	48	14
TOTAL	**$ 6,144**	**$ 4,640**	**$ 616**

Other	Grades K–12	Postsec	All Other
American Samoa	$ 26	$ 4	$ 1
Freely Associated States	7	16	0
Guam	43	15	4
Indian set-aside	247	-	43
Northern Mariana Islands	18	4	1
Puerto Rico	682	890	69
Virgin Islands	25	5	3
All Other	329	-	2
TOTAL	**$ 1,376**	**$ 934**	**$ 123**

THE DEPARTMENT'S APPROACH TO PERFORMANCE MANAGEMENT

PERFORMANCE MANAGEMENT FRAMEWORK

The ***Government Performance and Results Act Modernization Act of 2010*** **(GPRAMA)** requires agencies to establish a strategic plan that presents the long-term goals that the agency intends to accomplish. GPRAMA requires agencies to establish a **four-year strategic plan** at the beginning of each Administration. The Strategic Plan describes the key policy and operational priorities for the agency, detailing the Department's strategic performance goals that will guide human capital and budget planning.

Throughout Fiscal Year (FY) 2017, the Department conducted a series of strategic planning meetings to develop the *FY 2018–22 Strategic Plan*. These meetings included a focus on capturing lessons learned and developing a framework for the new Strategic Plan. The Department also consulted with Congress and the **Office of Management and Budget** (OMB). The Department plans to publish the *FY 2018–22 Strategic Plan* with the President's FY 2019 Budget in February 2018. Questions or comments about the Department's performance management framework and reporting should be e-mailed to **PIO@ed.gov**.

INFORMATION IN THE *AGENCY FINANCIAL REPORT*

The Department has elected to produce separate financial and performance reports. The *Agency Financial Report* for FY 2017 provides a high-level description of performance measures and goals based on the *FY 2014–18 Strategic Plan*. A detailed discussion of performance information for FY 2017 will be provided in the Department's *Annual Performance Report* to be released at the same time as the President's FY 2019 Budget. The Department's annual performance reports for prior years are available **online**. We also urge readers to seek programmatic data as it is reported in the **Congressional Budget Justification**, as well as on the web pages of **individual programs**.

The high-level discussion of performance information in this year's AFR includes performance matters that inform decisions of the Department and its partners. Discussions about the most serious management challenges the Department faces from the perspective of the Department's Office of Inspector General are provided in the Other Information section of the report.

AGENCY ACHIEVEMENTS AND LOOKING AHEAD

The U.S. Department of Education's mission is to promote student achievement and preparation for global competitiveness by fostering educational excellence and ensuring equal access. This mission is manifested in the Department's efforts to continually improve the educational environment for all students, and address their education needs. The Department's **National Center for Education Statistics** (NCES) estimates that 50.7 million students are attending public elementary and secondary schools in the fall of 2017, with a projected 35.6 million in prekindergarten through grade 8 and a projected 15.1 million in grades 9 through 12. An additional 5.2 million students are expected to attend private elementary and secondary schools. In fact, NCES predicts that the total P–12 enrollment will continue to grow to an all-time high of 56.8 million by 2026, indicating the increasing need for the highest quality agency performance.

Looking to the future, the Department plans to focus in the key areas of: (1) supporting state and local efforts to improve learning outcomes for all P–12 students in every community; (2) expanding postsecondary education options and improving outcomes to foster economic opportunity and informed, thoughtful, and productive citizens; (3) strengthening the quality, accessibility, and use of education data through better management, increased privacy protections, and transparency; and (4) reforming the effectiveness, efficiency, and accountability of the Department.

SUPPORTING STATE AND LOCAL EFFORTS TO IMPROVE LEARNING OUTCOMES FOR P–12 STUDENTS

In March, the Department released a revised **consolidated state plan template** to support states in meeting the requirements of the ***Elementary and Secondary Education Act of 1965*** (ESEA), as amended by the *Every Student Succeeds Act* (ESSA). The Department worked with state educational agencies (SEAs), and other state and local stakeholders, to develop a revised template that is structured to reduce burden and promote innovation, flexibility, transparency, and accountability, while maintaining essential protections for all students. The revised template asks states only to provide detail on their plans in areas (a) explicitly required by law and (b) deemed absolutely necessary for consideration of such a plan, consistent with ESEA section 8302(b)(3), leveraging input of states, local educators, and parents. State plans have been submitted to the Department, peer-reviewed, and approved.

Looking Ahead: Every student—regardless of background or circumstance—deserves an opportunity to fulfill his or her potential. High-quality educational opportunities are critical when it comes to achieving that goal, especially for the most vulnerable students and communities. The **President's FY 2018 Budget** is an indication of the commitment to support the most vulnerable. Level funding of the **Title I Grants program** totaling $14.9 billion would be allocated to local educational agencies' programs to support state and local efforts to ensure that more than 25 million students in high-poverty schools have access to rigorous coursework and teaching. Additionally, the federal investment in the ***Individuals with Disabilities Education Act*** formula grant programs at $12.7 billion would support services to 6.8 million children with disabilities and to states to design and implement special education program improvement efforts under the Department's **Results Driven Accountability** framework. The **English Language Acquisition program** would receive $736 million to implement effective language instruction programs designed to help English learners attain English language proficiency.

The Administration's education priority is to help ensure every student in America has an equal opportunity for a great education by giving parents more control and greater options. The proposed FY 2018 budget includes a $167 million increase for the **Charter Schools Grants program** to strengthen state efforts to start new charter schools or expand and replicate existing high-performing charter schools while providing up to $100 million to meet the demand for charter school facilities.

The Department is also focused on promoting evidence-based decision making with the intention to support states and districts in using and building evidence effectively. To this end, in FY 2017, the Department published revised evidence definitions and related selection criteria for competitive grant programs in Education Department General Administrative Regulations that align with ESSA; disseminated nonregulatory guidance on evidence in ESSA, ***Using Evidence to Strengthen Education Investments***, which contains a five-step decision-making framework that shapes evidence as a mechanism for continuous improvement and recommends criteria for each of the four evidence levels in ESSA; awarded $16 million to support rigorous evaluations and researcher-practitioner partnerships focused on state and local education priorities; and awarded 60-month contracts for nine Regional Educational Laboratories, which work in partnership with states and districts to bridge research, policy, and practice in education.

EXPANDING POSTSECONDARY EDUCATION OPTIONS AND IMPROVING OUTCOMES

With the passage of the FY 2017 spending bill, year-round Pell grants were restored, and the Department announced that these grants would become available to college students beginning July 1, 2017. The **Department recommended** that unless a student had remaining eligibility from the 2016–17 award year, institutions should award Pell Grant funds for this past summer out of the 2017–18 award year since the additional funding will be available later in the year (e.g., spring or summer of 2018). The change allows an eligible student to receive up to 150 percent of the student's scheduled Pell Grant for an award year beginning with the 2017–18 award year. This change gives hundreds of thousands of college students more resources to finish their coursework in a timeframe meeting their individual needs. Students will be able to graduate more quickly and with less debt.

The Department is transforming how **Federal Student Aid** (FSA) provides customer service to more than 42 million student loan borrowers. FSA customers will transition to a new processing and servicing environment in 2019, providing a customer support system that will give a better experience for students and benefits for taxpayers. The **FSA Next Generation Processing and Servicing Environment** will provide for a single data processing platform to house all student loan information while also allowing for customer account servicing to be performed either by a single contract servicer or by multiple contract servicers. This approach is expected to require separate acquisitions for database housing, system processing, and customer account servicing, allowing for maximum flexibility. These changes to the servicing and processing environment are expected to provide the opportunity for additional companies to submit proposals for contracting with FSA.

The Department **issued a reset**, or pause, regarding two postsecondary regulations—Borrower Defense to Repayment, concerning forgiveness of student loan debt, and Gainful Employment, concerning educational programs that prepare students for gainful employment in a recognized occupation. Two negotiated rulemaking committees have been established to rethink these two higher education regulations, with the intent to develop fair, effective, and improved regulations to protect individual borrowers from fraud, ensure accountability across institutions of higher education, and protect taxpayer interests. It is the Department's aim to protect students from predatory practices while also providing clear, fair, and balanced rules for colleges and universities to follow.

Looking Ahead: Year-round Pell grants were proposed in the 2018 President's Budget, which should safeguard and strengthen the Pell Grant program by level funding the discretionary appropriation and the year-round Pell grants. It is estimated that year-round Pell grants will increase aid available to eligible students by $16.3 billion over 10 years.

In an effort to address the fact that student loan financing can be confusing for millions of students and families who want to invest in postsecondary education, the 2018 budget proposal lays out changes in repayment and loan forgiveness plans for new borrowers after July 1, 2018. The changes simplify loan repayment for students by replacing five different income-driven repayment plans with a single plan aimed at prioritizing expedited loan repayment for undergraduate borrowers. These changes will save taxpayers an estimated $143 billion over the next decade while insulating current borrowers from changes to their loan programs. Proposed funding of $492 million is intended to help close gaps among racial and socioeconomic groups in college enrollment and degree attainment by improving academic programs, institutional capacity and student support services for Historically Black Colleges and Universities, Minority-Serving Institutions, and Hispanic-Serving Institutions. The proposed budget also provides $808.3 million for students from disadvantaged backgrounds, who are part of the **Federal TRIO Programs** and $219 million for those in the **Gaining Early Awareness and Readiness for Undergraduate Programs**.

STRENGTHENING THE QUALITY, ACCESSIBILITY, AND USE OF EDUCATION DATA

The Department's **College Scorecard** supports postsecondary students by providing the public with clear, easily accessible, and critical information on college performance. Feedback from the intended users—students, parents, counselors, and others—helps determine the design of the site and the information it contains. The College Scorecard integrates self-reported data from institutions of higher education collected by NCES with administrative data from FSA and U.S. Department of Treasury's tax data. The Department established a data-sharing agreement with Treasury's Statistics of Income (SOI) for five years to obtain administrative earnings data to inform the College Scorecard. The Department will continue to provide SOI with individual-level data on several cohorts of students from all Title IV institutions and receive back institution-level data on salary after attending the institution. Most recently, the Department developed a user-requested comparison tool feature for the College Scorecard to allow users to compare multiple school profiles and data points at once.

The Department's **National Assessment of Educational Progress** (NAEP), the largest nationally representative and continuing assessment of student knowledge in various subject areas, is evolving to address schools' transition to digitally based assessments. Since 1969, NAEP has provided a common measure of student achievement across the country, continuing to explore new testing methods and question types that reflect the growing use of technology in education, and continuing to work to be paperless.

The Department's InformED initiative is intended to transform how the Department makes information available—and actionable—for internal users and for the public. Through a cross-office steering committee, InformED has led in the identification and development of high-priority open data initiatives. In addition, to ensure coordination around the collection, use, and analysis of agency data, the Department has supported the Data Strategy Team with representatives from the Department's Office of Management, NCES, and Office of Planning, Evaluation and Policy Development.

Looking Ahead: The President's Budget includes $616.8 million for the Department's Institute of Education Sciences to continue to support state and local-based research, evaluations, and statistics that help educators, policymakers, and other stakeholders improve student outcomes. $42 million is suggested for **Supporting Effective Educator Development** grants to provide evidence-based professional development activities and prepare teachers and principals from nontraditional preparation and certification routes to serve in high-need LEAs.

$120 million is suggested for **Education Innovation and Research (EIR)** grants to develop and expand the evidence base for effective interventions and innovations responding to other education needs, including those identified by Secretarial priorities and those emerging from the field. This continued investment is particularly necessary in light of new ESEA requirements for states and school districts to support the use of evidence-based interventions in schools identified for comprehensive support and improvement or implementing targeted support and improvement plans. Robust Federal investment in identifying such interventions through the EIR program is essential to ensuring that LEAs have the tools they need to address the persistent challenges in their lowest-performing schools.

REFORMING THE EFFECTIVENESS, EFFICIENCY, AND ACCOUNTABILITY OF THE DEPARTMENT

In response to President Trump's **Executive Order 13777, *Enforcing the Regulatory Reform Agenda***, the Department established a Regulatory Reform Task Force that has catalogued over 150 regulations and more than 1,700 items of policy guidance at the Department. The task force, comprised of agency political appointees and career staff, provided recommendations on which regulations and guidance documents to repeal, modify, or keep in an effort to ensure those items that remain adequately protect students while giving states, institutions, teachers, parents, and students the flexibility to improve student achievement. Each principal office has made initial recommendations to the task force whether regulations and guidance under its purview meet the Order's criteria for repeal, replacement, or modification. As previously discussed, candidates for modification that have been identified include the Gainful Employment and Borrower Defense to Repayment, and a reset for these regulations is underway.

Also, in response to **Executive Order 13781, *Comprehensive Plan for Reorganizing the Executive Branch***, which requires development of a plan to enhance employee performance, the Department submitted an Agency Reform Plan to OMB, describing proposals the Department is considering. For the OMB submission, work groups considered the areas of: (a) reviewing potential reform areas, (b) determining if reform is needed or helpful and whether reform will benefit the agency and the public, and (c) developing proposals for implementing the reform if the work group determines it is needed or helpful. Agency staff continue to assess reform factors that include: new activities or functions the Department should initiate; ways the agency can be more efficient in meeting the needs of students, families, and education partners; activities or functions the Department should consider combining or modifying; agency activities or functions that duplicate what others are doing; and how the Department could best deliver the education services or products to students and educators.

Looking Ahead: The Department intends to continue to build on what's working well to create an agency that better serves America's students and educators. Beginning with its FY 2018 Annual Performance Report, the Department will report the appropriate performance data for performance indicators that will relate to deregulatory actions, as outlined in the **Executive Order 13777**. The results of this internal reform will better align and support the new strategic plan, which is the basis for the Department's performance management framework. The Department uses quarterly performance reviews, targeted strategic initiatives, and outreach to leaders and stakeholders to assess progress and garner engagement toward achieving strategic goals and outcomes. The *FY 2018–22 Strategic Plan* will be published with the President's FY 2019 Budget.

FORWARD-LOOKING INFORMATION

This section summarizes information pertinent to the Department's future progress and success.

DIRECT LOAN PROGRAM

The Department's largest program, the William D. Ford Federal Direct Loan (Direct Loan) program, provides students and their families with funds to help pay for their postsecondary education costs. Easing the burden of student loan debt is a significant priority for the Department. The following is a discussion of (1) the steps the Department has taken to ensure that student debt is manageable and (2) the risks inherent in estimating the cost of the program.

Managing Student Loan Debt

Each year, federal student loans help millions of Americans obtain a college education—an investment that, on average, has high returns. While the average return to a college degree remains high, substantial inequities in outcomes exist, and some students leave school poorly equipped to manage their debt, whether due to limited labor market opportunities or high debt.

Traditionally, federal loans of this type have had flat 10-year repayment schedules, making it difficult for borrowers to pay at the start of their career when their salaries are lower. The recent expansion of income-driven repayment plans grants students the opportunity for greater financial flexibility as it pertains to their monthly payment. For more details on these plans, visit FSA's **How to Repay Your Loans Portal**.

As the labor market declined during the financial crisis of 2008, serious challenges in student debt repayment came to the forefront of conversations. The availability of income-driven repayment plans like Pay As You Earn (PAYE) and an improving labor market has led to substantial improvement, signifying Departmental progress in the focus area of higher education, namely, its efforts to innovate loan program guidelines in order to make student loan debt more manageable for borrowers across the board. Recent trends in student loan repayment data show that:

- More than 80 percent of Direct Loan recipients with loans in repayment are current on their loans.
- Growing numbers of borrowers are taking action and responsibility with regard to their student loans when they are in need of modifications and support. As of June 2017, nearly 6.3 million Direct Loan recipients were enrolled in income-driven repayment plans, representing a 19 percent increase from June 2016 and a 62 percent increase from June 2015.

The Department has made progress in this area and continues to work relentlessly to make student debt more manageable. Looking to the future, the Department will build on its recent successes by:

- Conducting significant outreach efforts to inform student loan borrowers of their repayment options, including the protections provided by income-driven repayment plans.
- Ensuring that borrowers have access to an affordable repayment plan, high-quality customer service, reliable information, and fair treatment.
- Continuing to support additional tools like the College Scorecard and Financial Aid Shopping Sheet to increase transparency around higher education costs and outcomes, in an effort to help students and families make informed decisions before college enrollment.

Managing Risks and Uncertainty Facing the Direct Loan Program's Cost Estimates

Direct Loan program costs are estimated consistent with the requirements of the *Federal Credit Reform Act of 1990*. Under the Act, the future costs and revenues associated with a loan are estimated for the entire life of the loan, up to 40 years in this case. The actual performance of a loan cohort tends to deviate from the estimated performance during that time, which is not unexpected given the inherent uncertainty involved in developing estimates. There are four types of risk that make estimating lifetime program costs a difficult task.

Legislative, Regulatory, and Policy Risk

There are inherent risks from the possibility that the cost structure of the Direct Loan program may be altered through legislative, regulatory, or administrative action. In addition, recent legislative, regulatory, and policy action may be difficult to interpret with regard to effects on financial modeling and estimation, given the lack of actual trend data availability. Some examples of current risks include the following:

Income-Driven Repayment Plans: Several new income-driven repayment plans have been introduced in recent years, including Income-Based Repayment, PAYE, and Revised Pay As You Earn. In general, the proliferation of plans has made income-driven repayment terms more generous (and more costly to the government) and made the plans available to a greater number of borrowers. Having more plans complicates repayment plan selection, since the tradeoffs between available plans vary by borrower and may not always be entirely clear. Selected comparisons between projected originations and borrower repayments under the different income-driven repayment plans are available on the **Department's website**. The Department has also engaged in outreach campaigns to broaden borrower awareness of these plans. However, future commitment to market and increased participation in these plans are areas of uncertainty.

Public Service Loan Forgiveness: Enacted in 2007, the Public Service Loan Forgiveness (PSLF) program allows a Direct student loan borrower to have the balance of their Direct student loans forgiven after having made 120 qualifying monthly payments under a qualifying repayment plan, while working full time for a qualifying public service employer (such as government or certain types of nonprofit organizations). In general, forgiveness provided via PSLF raises the cost of the Direct Loan program; however, there is still uncertainty as to how many borrowers will take advantage of the program. Much of this uncertainty arises because borrowers do not need to apply for the program until after having made the 120 qualifying monthly payments. While data on current applications is helpful to gauge potential forgiveness, it may not be representative of final participation figures. In addition, since the first date by which a borrower could receive forgiveness under this program is October 1, 2017, the Department does not yet have a robust set of actual forgiveness data. The available data on borrowers who have already certified their employment, nearly 740,000 borrowers as of September 2017, is less valuable than it appears since it does not track breaks in their repayment or qualifying employment. The Department continues to remain informed on, and manage the risk that may arise in relation to, the uncertainty about the effect of further borrower outreach on boosting participation in the PSLF program.

Borrower Defense: In May 2015, Corinthian Colleges, Inc. (Corinthian), a publicly traded company operating numerous postsecondary schools that enrolled over 70,000 students at more than 100 campuses nationwide, filed for bankruptcy under deteriorating financial conditions and while subject to multiple state and federal investigations. The Department received thousands of claims for student loan relief from Corinthian students under a provision in the *Higher Education Act of 1965* (HEA) referred to as "borrower defense." Valid borrower defense claims would lead to the discharge of borrower debt, thus increasing the cost of the Direct Loan program to taxpayers. However, it is unknown how many of the claims are valid. Since Corinthian, several other postsecondary schools have closed under similar circumstances, including ITT Technical Institute.

In August 2015, the Department initiated a rulemaking process to establish a more accessible and consistent borrower defense standard to clarify and streamline the borrower defense process to protect borrowers. The legality of this rule has since been challenged in court (*California Association of Private Postsecondary Schools v. DeVos*) and certain provisions of the rule have been subsequently delayed. In addition, the Department has initiated a new rulemaking process to consider potential changes to the original rule. The overall level of activity that could lead to valid borrower defense claims, particularly in the for-profit postsecondary sector, coupled with the uncertainty as to the framework of the final rule, make projections as to the financial impact exceedingly difficult. The Department continues to monitor instances of this risk factor to its programs.

Estimation Risk

Actual student loan outcomes may deviate from estimated student loan outcomes, which is not unexpected given the long projection window of up to 40 years. The Direct Loan program is subject to a large number of future borrower level events and economic factors that heavily impact the ultimate cost of issued loans. For example, estimates that need to be made for loans originating in FY 2017 include how long students will remain in school; what repayment plan will be chosen; whether the loan will be consolidated; whether the borrower will die, become disabled, bankrupt, or have another claim for discharge or forgiveness (closed school, borrower defense, etc.); if the loan will go into deferment or forbearance; if the loan will go into default and, if so, what collections will be received on the defaulted loan; and, if the loan is in income-driven repayment, what the borrower's employment (public sector or not) and income and family status will be over the next 25 years. These types of projections are not only extremely difficult to make but also are subject to change if future student behaviors deviate from past experience. Changes in private student loan markets, such as the recent increase in refinancing of federal student loans into private student loans, also add a layer of uncertainty to student loan estimates. Lastly, the Direct student loan portfolio has grown from around $380 billion in FY 2011 to around $1.06 trillion as of the end of FY 2017. This growth naturally results in increased re-estimates, since a re-estimate worth 1 percent of the portfolio today would be more than twice as large as a similar re-estimate in FY 2011 ($10.6 billion vs. $3.8 billion).

Macroeconomic Risk

The ultimate amount, timing and value of future borrower repayments under the Direct Loan program are heavily affected by certain economic factors, especially since the introduction of income-based repayment plans. Some examples include the following:

Interest Rates: Direct Loan subsidy estimates are very sensitive to changes in interest rates. Recent interest rate history has been atypical, as interest rates have continued to remain lower than their historical averages. Under the current program terms, the fixed borrower rates for direct loans are established in advance of the upcoming school year, while the Treasury fixed interest rate on borrowings to fund those loans is not set until after those awards are fully disbursed, which can be as much as 18 months later. Unexpected changes in interest rates during this time can significantly impact the subsidy cost of these loans.

Unemployment: The financial crisis of 2008 and ensuing spike in unemployment rates had a dramatic effect on both student loan volume and student loan performance. Student loan volume peaked along with unemployment, as many displaced workers sought higher education opportunities. Student loan performance suffered as many borrowers repaying their loans were left with much less disposable income with which to make their loan payments. For example, the default rate for students was at a high of 14.7 percent for loans entering repayment in 2010, while the most recent rate is 11.5 percent for loans entering repayment in 2014. While recessions and economic downturns are cyclical phenomena, their exact timing and impact on the cost estimates remain an area of uncertainty.

Wage Growth: The estimated costs of income-driven repayment plans are largely dependent on trends in observed wage growth. To the extent that future wage growth deviates significantly from prior wage growth, actual costs of income-driven repayment plans may deviate from projected estimated costs. The Department continues to manage risks in this area by continuing to learn about its borrower base and remain informed on such labor market statistics.

Operational Risk

Unforeseen issues in administering and servicing student loans may impact the cost estimates. For example, in March 2017, a tool used to automatically transfer a family's tax information to both student aid applications and income-driven repayment (IDR) plan applications was taken down due to security concerns. Although usage of the tool for IDR recertification has since been brought back up, it is yet uncertain what, if any, impact this outage may have had on student loan cost estimates. However, this example highlights that there is an inherent risk that future, unpredictable disruptions in the administrative status quo may impact student loan cost estimates.

CONTINUOUS IMPROVEMENT

Improving critical infrastructure, systems, and overall capacity, and ensuring sound strategic decision making regarding allocation of resources are essential to the Department's future progress and success. Exploring the expanded use of shared services and incorporating enterprise risk management into Department decision making are two of the Department's key initiatives.

Shared Services

The Department of Education uses shared services where feasible and practical, including payroll and travel. The Department will explore other options to further leverage shared services for other mission support areas in the coming years.

Enterprise Risk Management

The Department plans to implement Enterprise Risk Management (ERM) practices by integrating its existing risk management processes and governance bodies into a suitable ERM framework and including risk as a central element in all critical day-to-day and strategic decision-making activities. The Department will also develop a more risk-aware culture that facilitates increased focus on the wide range of risks the Department faces and fosters more open discussions about how those risks might impact the accomplishment of the Department's mission and whether allocation of resources is aligned to best mitigate risks to an acceptable level. The Senior Management Council will oversee the implementation of ERM in accordance with OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control.*

FINANCIAL HIGHLIGHTS

INTRODUCTION

This section provides summarized information and analyses about the Department's assets, liabilities, net position, sources and uses of funds, program costs, and related trend data. It also provides a high-level perspective of the detailed information contained in the financial statements and related notes.

The Department consistently produces complete, accurate, and timely financial information. The Department's financial statements and notes are prepared in accordance with accounting principles generally accepted in the United States for federal agencies issued by the Federal Accounting Standards Advisory Board (FASAB) and the format and content specified by OMB Circular No. A-136, *Financial Reporting Requirements*. The financial statements, notes, and underlying business processes, systems, and controls are audited by an independent accounting firm with audit oversight provided by the Office of Inspector General (OIG). For 16 consecutive years, the Department has earned an unmodified (or "clean") audit opinion. The financial statements and notes for FY 2017 are on pages 32–69 and the Independent Auditors' Report begins on page 78.

BALANCE SHEET

The consolidated balance sheet presents, as of a specific point in time (the end of the fiscal year), the Department's total assets, total liabilities, and net position.

The Department's assets totaled $1,259.2 billion as of September 30, 2017. The vast majority of the assets relate to credit program receivables, which comprised 91.1 percent of all assets. Direct loans comprise the largest share of these receivables, totaling $1,041.6 billion. All other assets totaled $112.5 billion, most of which was Fund Balance with Treasury.

The Department's liabilities totaled $1,202.1 billion as of September 30, 2017. As with assets, the vast majority of the Department's liabilities are associated with credit programs, primarily amounts borrowed from the U.S. Department of the Treasury (Treasury) to fund student loans. This debt totaled $1,180.1 billion as of September 30, 2017.

Figure 1. Assets by Type

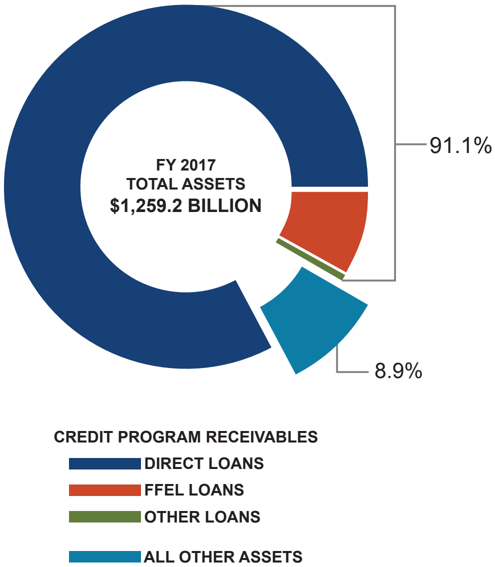


Figure 2. Liabilities by Type

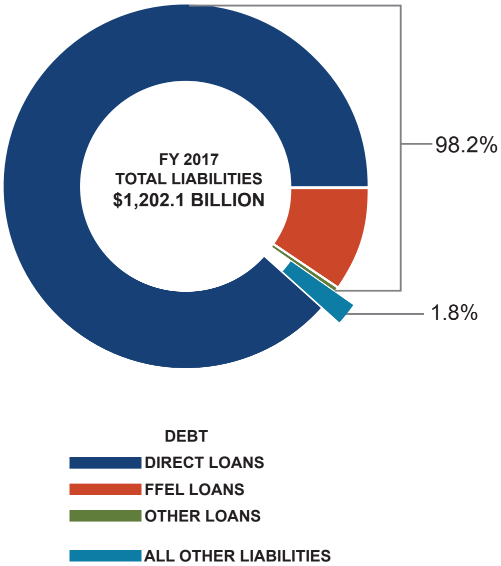


Figure 3. Components of Direct Loan Receivables, Net
(Dollars in Billions)

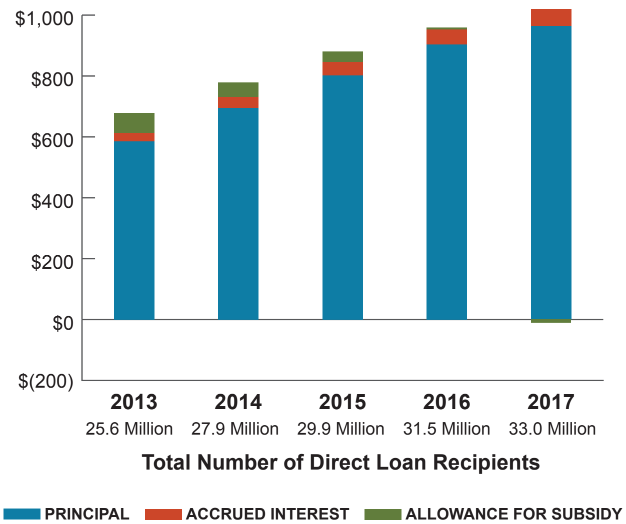


Figure 3 shows the changes in the Direct Loan receivables components over the past five years. The principal continues to grow as the Direct Loan program has originated all new federal loans since July 2010. However, the rate of increase in principal has slowed, as the Direct Loan program has originated fewer new loans each year since FY 2013 as a result of stagnant and in some cases declining enrollment, coinciding with the recovery from the 2007–09 recession. Even so, new loan disbursements continue to exceed overall loan principal repayments—student loan borrowers now have more options to stretch out their repayment terms and reduce their monthly payments.

In accordance with the *Federal Credit Reform Act of 1990* (FCRA), the Department's financial statements report the value of direct loans and loan guarantees (credit program receivables) at the net present value of their future cash flows, discounted at a fixed rate established based on Treasury securities. The difference between the recorded principal and interest balance and the net present value of the loans is referred to as the "allowance for subsidy," which can be positive or negative.

Prior years' positive allowance for subsidy balances represented estimates of funds expected to be recovered in excess of principal loaned less anticipated defaults, loan cancellations, and other adjustments. These positive allowance for subsidy balances resulted primarily from the difference between the interest rates charged by the Department to borrowers and the interest rates charged to the Department on amounts borrowed from Treasury to make the loans. The reduction in the positive allowance since FY 2013 is due primarily to higher subsidy costs to the government, the main cause being increasing participation in income-driven repayment plans discussed elsewhere in this AFR as (a) new plans have become available that are more advantageous to borrowers, (b) new plans have become available that expand the potential pool of borrowers, and (c) the Department has conducted targeted outreach to borrowers to make them aware of their potential eligibility for these plans. During FY 2017, the allowance for subsidy changed from a positive to a negative balance. In practical terms, this means that the present value of funds expected to be recovered is now less than the principal loaned, which represents an increased cost to the taxpayer.

Table 1 shows the payment status of the Direct Loan principal and interest balances outstanding over the past 5 years. The Current Repayment category consists of loans that are being paid back on time, including the current portion of loans refinanced pursuant to income-driven repayment plans.

Table 1. Payment Status of Direct Loan Principal and Interest Balances
(Dollars in Billions)

Loan Status	Fiscal Year				
	2013	2014	2015	2016	2017
Total Dollar Amount of Direct Loans Outstanding	**613.8**	**731.2**	**845.1**	**953.6**	**1,058.4**
Current Repayment	188.5	247.2	332.0	406.8	467.9
In School, Grace Period, and Education Deferments	265.5	281.8	284.3	289.6	291.7
Forbearance and Noneducation Deferments	70.5	97.8	103.0	106.5	122.5
Delinquent	47.8	54.6	65.1	71.8	79.5
Default/ Bankruptcy/Other	41.5	49.8	60.7	78.9	96.8
Total No. of Direct Loan Recipients (in Millions)	**25.6**	**27.9**	**29.9**	**31.5**	**33.0**

Loans in the Delinquent category are considered in "repayment" status, but payments are anywhere from 31 to 360 days late. Default/Bankruptcy/Other includes loans that are over 360 days delinquent (default status); loans in a nondefaulted bankruptcy status; and loans in disability status. The percentage of loans in default continues to grow, even as delinquencies and new defaults have declined, because defaulted loans can be difficult to collect on or rehabilitate. The percentage of the portfolio in current repayment, which rose from 31 percent in FY 2013 to 44 percent in FY 2017, has eclipsed payments temporarily postponed and has grown far faster than loans in default.

The Department borrows funds from the Treasury to disburse new loans and pay credit program outlays and related costs. The Department repays Treasury after consideration of cash position and the liability for future cash outflows. Figure 4 shows the Direct Loan program cumulative borrowing and repayment activity since the inception of the program that resulted in the debt amount on the balance sheet. Figure 6 (see page 16) illustrates the Direct Loan program financing process and provides financing and disbursing trend data.

STATEMENT OF NET COST

The consolidated statement of net cost reports the Department's components of the net costs of operations for a given fiscal year. Net cost of operations consists of the gross cost incurred less any exchange (i.e., earned) revenue from activities. Gross cost is composed of the cost of credit and grant programs, and operating costs. Exchange revenues are primarily interest earned on credit program loans. Figure 5 shows the Department's gross costs and earned revenues over the past five years.

Figure 4. Direct Loan Program Cumulative Financing Activity
(Dollars in Billions)

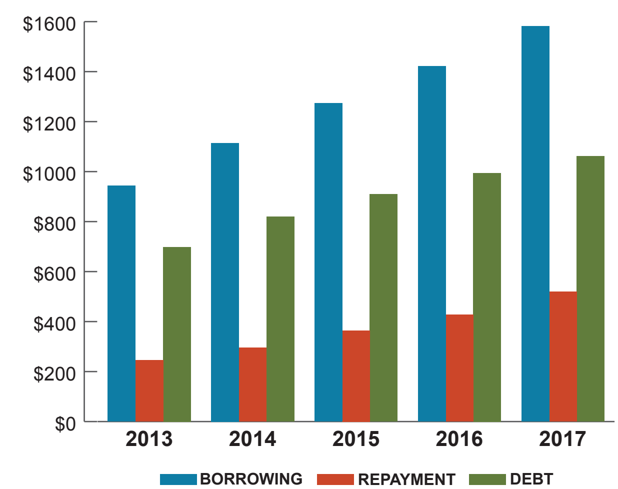


Figure 5. Gross Cost & Earned Revenue
(Dollars in Billions)

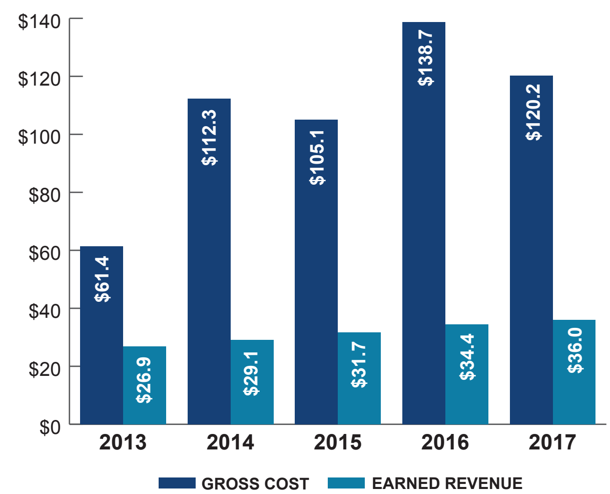
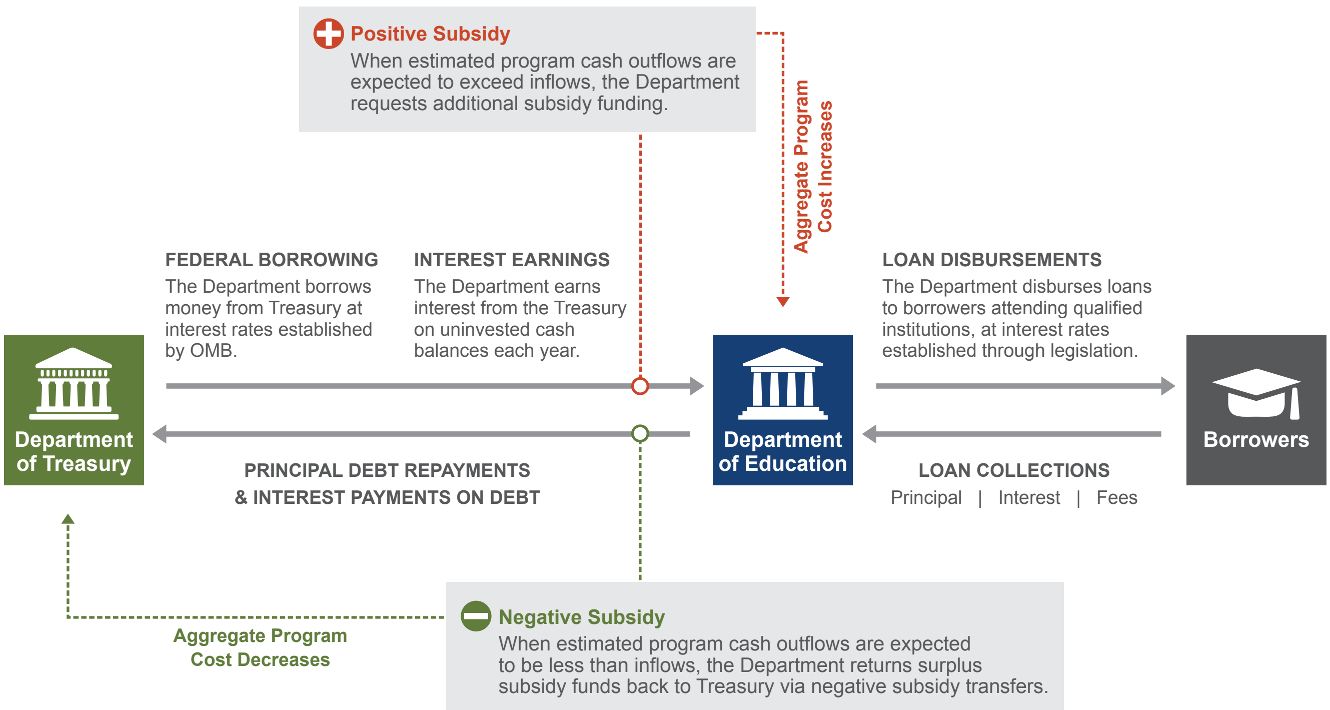


Figure 6. William D. Ford Federal Direct Loan Program: *Following the Funding*



Treasury Financing and Subsidy Cost of Direct Loans (Dollars in Billions)					
Fiscal Year	2013	2014	2015	2016	2017
Net Borrowing	**149.0**	**120.6**	**90.9**	**84.4**	**67.3**
Borrowing from Treasury	177.7	171.2	159.7	147.0	160.5
Debt Repayments to Treasury	(28.7)	(50.6)	(68.7)	(62.6)	(93.2)
Interest Expense to Treasury	(22.7)	(25.2)	(27.6)	(30.5)	(31.3)
Interest Earned from Treasury	3.4	3.7	4.2	3.9	4.3
Cumulative Taxpayer Cost / (Savings)	(65.2)	(47.4)	(35.5)	(5.3)	16.8
Current Subsidy Expense (Revenue)	(39.6)	8.1	(0.9)	16.1	5.3

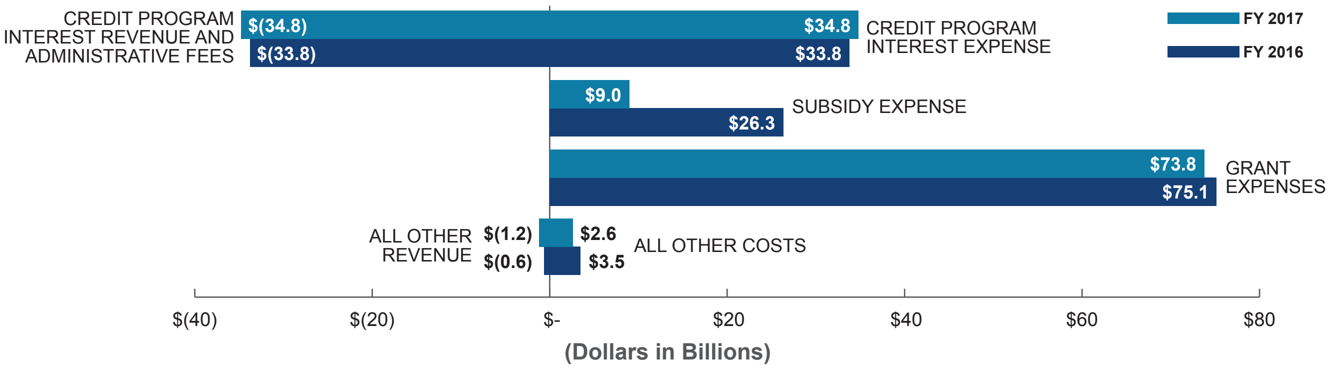
Direct Loan Program Cash Transactions with Borrowers (Dollars in Billions)					
Fiscal Year	2013	2014	2015	2016	2017
Loan Disbursements	**129.5**	**134.1**	**142.2**	**140.5**	**142.5**
Stafford Subsidized	26.5	25.9	24.0	23.8	23.4
Stafford Unsubsidized	56.1	54.7	52.7	52.3	51.4
Parent PLUS	19.4	18.9	19.2	19.0	18.7
Consolidation[1]	27.5	34.5	46.4	45.5	49.0
Loan Collections	**36.2**	**48.8**	**65.1**	**73.2**	**82.0**
Principal	26.4	36.3	50.0	55.9	62.6
Interest	8.1	10.8	13.4	15.5	17.6
Fees	1.7	1.8	1.8	1.8	1.9

[1] Consolidation disbursement amounts stem from a number of loan programs, including most notably FFEL, in addition to Direct Loans.
Numbers may not add up due to rounding.

The major components of the Department's gross cost and earned revenue are shown in Figure 7 and include:

- Credit program interest expense offset by credit program interest revenue and administrative fees as the result of subsidy amortization;
- Credit program subsidy expense (see also Figure 8); and
- Grant expenses (see also Figure 9).

Figure 7. Major Components of Gross Cost and Earned Revenue

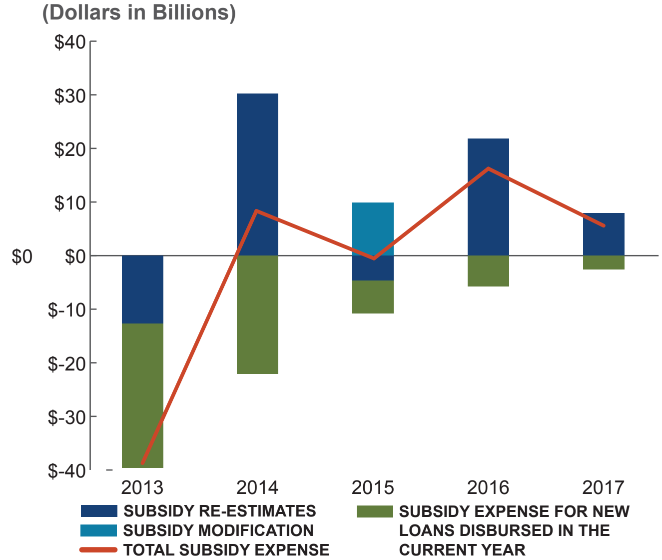


One of the components significantly impacting the Department's gross costs pertains to the estimated subsidy expense of the Direct Loan program. The Department's gross costs can fluctuate significantly each year as a result of changes in the estimated subsidy expense. Subsidy expense is an estimate of the cost of providing direct loans, but excludes the administrative costs of issuing and servicing the loans. The Department estimates subsidy expense using economic models that project cash flows on a net present value basis.

The Department estimates subsidy costs annually for new loans disbursed in the current year; updates the previous cost estimates for outstanding loans disbursed in prior years (subsidy re-estimates); and updates previous cost estimates based on changes to terms of existing loans (subsidy modifications). Figure 8 shows these three components of the Direct Loan program subsidy expense for the past five years.

Factors such as interest rates charged to the borrower, interest rates on Treasury debt, default rates, fees, and other costs impact the estimated cost calculation and determine whether the overall subsidy expense is positive or negative. Subsidy expense for new loans has been negative in recent years primarily because lending interest rates charged

Figure 8. Direct Loan Program Subsidy Expense
(Dollars in Billions)



	2013	2014	2015	2016	2017
Subsidy Expense for New Loans Disbursed in the Current Year	$(27.0)	$(22.1)	$(6.2)	$(5.7)	(2.6)
Subsidy Re-estimates	(12.6)	30.2	(4.6)	21.8	7.9
Subsidy Modification	-	-	9.9	-	-
Total Subsidy Expense—(negative) and positive	**$(39.6)**	**$8.1**	**$(0.9)**	**$16.1**	**5.3**

to student and parent borrowers were greater than the historically low rates at which the Department borrowed from Treasury. In practical terms, a negative subsidy and/or a downward re-estimate of prior years' subsidy occurs when the interest and/or fees charged to the borrower are more than sufficient to cover the interest on Treasury borrowings and the costs of borrower default. Conversely, a positive subsidy and/or an upward re-estimate of prior years' subsidy occurs when the interest and/or fees charged to the borrower do not cover the interest on Treasury borrowings and the cost of borrower defaults.

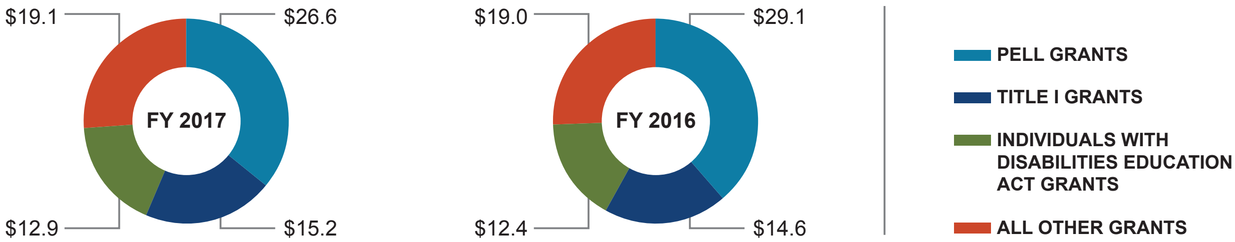
Direct Loan program re-estimated subsidy cost was adjusted upward by $7.9 billion in FY 2017. In addition to the major assumption updates described below, the re-estimate reflects several other assumption updates, including interest rates provided by the Office of Management and Budget, volume, and enter repayment rates. Prepayment rates increased from the FY 2016 estimate, resulting in a $2.4 billion upward re-estimate. Contract collection costs were updated for new data reflecting lower overall average commission rates, resulting in a $5.1 billion downward re-estimate.

- **IDR Model Changes.** The U.S. Government Accountability Office (GAO) audit, *Federal Student Loans: Education Needs to Improve Its Income Driven Repayment Plan Budget Estimates*, identified several areas in which the Department could improve its IDR cost estimates. Largely in response to this audit, as well as concerns raised in FY 2016's Independent Auditors' Report, in FY 2017 the Department incorporated an adjustment for inflation into the Department's IDR submodel, modified the current IDR submodel to estimate IDR subsidies by loan type, and implemented methods to address concerns regarding the volatility of the submodel's income data. In addition, default; collection; death, disability, and bankruptcy; and prepayment rate assumptions used by the submodel were updated. The combined effect of these changes was a net downward re-estimate of $14.7 billion.
- **Repayment Plan Selection.** The GAO audit referred to above also recommended the Department help ensure that subsidy estimates reasonably reflect trends in IDR plan participation. In response, the Department updated its methodology for repayment plan selection, taking into account the timing of repayment plan selection as well as recent growth trends in the selection of income-driven repayment plans. The combined effect of these changes was a net upward re-estimate of $18.4 billion.
- **Death, Disability, and Bankruptcy.** The Department made major updates to the death, disability, and bankruptcy assumption in FY 2017. These updates included a revised accounting for the effect of a matching agreement with Social Security Administration, updates to closed school regulations, and revised borrower defense regulations. Updates to the data used to calculate discharges were also incorporated. The combined effect of these changes was a net upward re-estimate of $9.2 billion.

The Department has more than 100 grant and loan programs (**www.ed.gov/programs/inventory.html**). The largest grant programs are shown in Figure 9 and include:

- **Pell Grants**—provides need-based grants to low-income undergraduate and certain postbaccalaureate students to promote access to postsecondary education. Students may use their grants at any one of approximately 5,400 participating postsecondary institutions. Grant amounts are dependent on: the student's expected family contribution; the cost of attendance (as determined by the institution); the student's enrollment status (full-time or part-time); and whether the student attends for a full academic year or less.
- **Title I Grants to Local Educational Agencies**—provides financial assistance through state educational agencies to local educational agencies and public schools with high numbers or percentages of poor children to help ensure that all children meet challenging state academic content and student academic achievement standards.
- **Individuals with Disabilities Education Act Grants**—provides formula grants to states to assist them in providing a free appropriate public education in the least restrictive environment for children with disabilities ages 3 through 21 and assists states in providing early intervention services for infants and toddlers from birth through age two and their families. Also provides discretionary grants to institutions of higher education, public agencies, and nonprofit organizations to support research, demonstrations, technical assistance and dissemination, technology, personnel development and parent-training and information centers.

Figure 9. Grant Costs by Major Program (Dollars in Billions)



In addition to student loans and grants, the Department offers other discretionary grants under a variety of authorizing legislation, awarded using a competitive process and formula grants, using formulas determined by Congress with no application process.

STATEMENT OF CHANGES IN NET POSITION

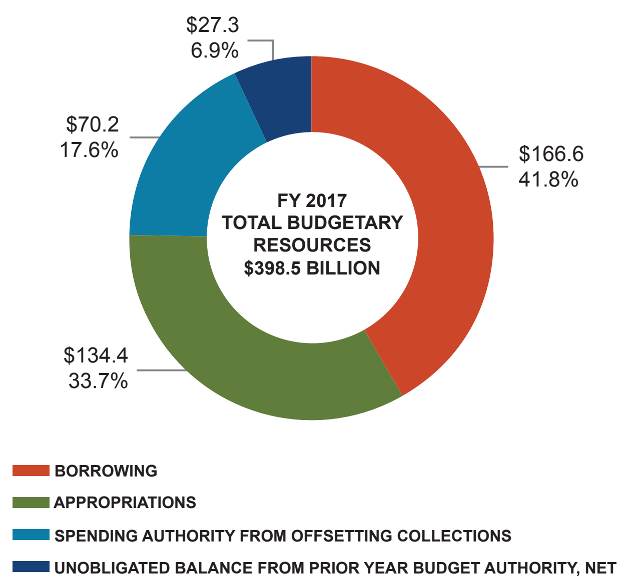
The consolidated statement of changes in net position reports the beginning net position, the summary effect of transactions that affect net position during the fiscal year, and the ending net position. Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include undelivered orders and unobligated balances for grant and administrative operations. Cumulative results of operations represent the net difference since inception between (1) expenses and (2) revenues and financing sources. Net position of the Department totaled $57.2 billion as of September 30, 2017. This reflects a 74.4 percent increase over the net position of $32.8 billion from the prior fiscal year.

STATEMENT OF BUDGETARY RESOURCES

The combined statement of budgetary resources presents information on how budgetary resources were made available and their status at the end of the fiscal year. Information in the statement is based on budgetary transactions as prescribed by OMB and Treasury.

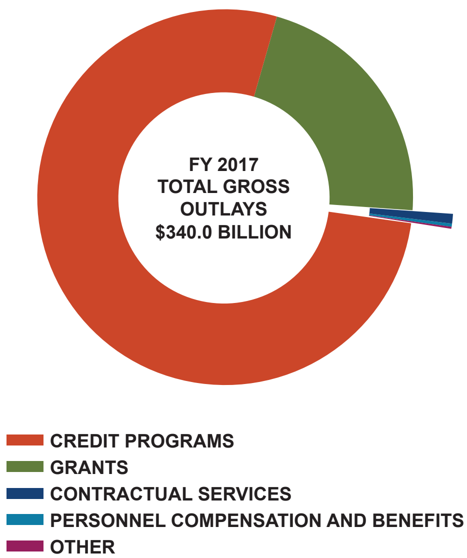
The Department's budgetary resources totaled $398.5 billion for the period ended September 30, 2017, increasing from $335.0 billion, or approximately 19.0 percent from the prior year. Budgetary resources are comprised of appropriated budgetary resources of $152.2 billion and non-budgetary credit reform resources of $246.3 billion. The non-budgetary credit reform resources are predominantly borrowing authority for the loan programs.

Figure 10. Budgetary Resources



The Department's gross outlays totaled $340.0 billion for the period ended September 30, 2017. Gross outlays are primarily comprised of credit program loan disbursements and claim payments, credit program subsidy interest payments to Treasury, and grant payments. Credit program gross outlays were offset by $168.2 billion of collections—primarily principal, interest and subsidy collections.

Figure 11. Gross Outlays by Type



	Billions	%
CREDIT PROGRAMS	**$ 263.0**	**77.4%**
DIRECT LOAN PROGRAM	237.0	69.7%
FFEL PROGRAM	25.2	7.4%
OTHER CREDIT PROGRAMS FOR HIGHER EDUCATION	0.8	0.2%
GRANTS	**$ 73.5**	**21.6%**
PELL GRANTS	26.9	7.9%
TITLE I GRANTS TO LOCAL EDUCATIONAL AGENCIES	15.2	4.5%
INDIVIDUALS WITH DISABILITIES EDUCATION ACT GRANTS	12.7	3.7%
ALL OTHER GRANTS	18.7	5.5%
CONTRACTUAL SERVICES	**$ 2.8**	**0.8%**
PERSONNEL COMPENSATION AND BENEFITS	**$ 0.6**	**0.2%**
OTHER	**$ 0.1**	**0.0%**
TOTAL	**$ 340.0**	**100.0%**

LIMITATIONS OF THE FINANCIAL STATEMENTS

Management has prepared the accompanying financial statements to report the financial position and operational results for the U.S. Department of Education for FY 2017 and FY 2016, pursuant to the requirements of Title 31 of the United States Code, section 3515(b).

While these statements have been prepared from the books and records of the Department in accordance with generally accepted accounting principles for federal entities and the formats prescribed by OMB, these statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

The statements should be read with the realization that they are a component of the U.S. government, a sovereign entity. The implications of this are that the liabilities presented herein cannot be liquidated without the enactment of appropriations, and that ongoing operations are subject to the enactment of future appropriations.

ANALYSIS OF SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

MANAGEMENT ASSURANCES

The Secretary of Education's 2017 Statement of Assurance provided below is the final report produced by the Department's annual assurance process. Although the Department has not identified any material weaknesses, it acknowledges that there are significant weaknesses and management challenges to be addressed that are identified elsewhere in this report.

STATEMENT OF ASSURANCE
FISCAL YEAR 2017
November 13, 2017

The Department of Education (the Department) management is responsible for meeting the objectives of the *Federal Managers' Financial Integrity Act of 1982* (FMFIA) by establishing, maintaining, evaluating and reporting on the Department's internal control and financial systems.

In accordance with Section 2 of FMFIA and Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, management evaluated the effectiveness of the Department's internal controls to support effective and efficient operations, reliable reporting and compliance with applicable laws and regulations.

Section 4 of FMFIA and the *Federal Financial Management Improvement Act of 1996* (FFMIA) require management to ensure the Department's financial management systems provide reliable, consistent disclosure of financial data. In accordance with Appendix D of OMB Circular A-123, management evaluated whether the Department's financial management systems substantially complied with FFMIA requirements. The Department also conducted a separate assessment of the effectiveness of its internal control over financial reporting, including controls designed to prevent, detect and recover improper payments, in accordance with Appendix A of OMB Circular A-123.

The Department has not identified any material weaknesses in operations, reporting or compliance with applicable laws and regulations.

Based on the results of the Department's assessments described above, our system of internal controls provides Department management with reasonable assurance that the objectives of sections 2 and 4 of the FMFIA were achieved as of September 30, 2017.

Betsy DeVos

Betsy DeVos

INTRODUCTION

Strong risk management practices and internal control help an entity run its operations efficiently and effectively, report reliable information about its operations and financial position, and comply with applicable laws and regulations. The **FMFIA** requires federal agencies to establish internal controls that provide reasonable assurance that agency objectives will be achieved. **OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*** implements FMFIA and defines management's responsibilities for ERM and internal control. The Circular provides guidance to federal managers to improve accountability and effectiveness of federal programs, as well as mission support operations through implementation of ERM practices and by establishing, maintaining, and assessing internal control effectiveness. The guidance requires federal agencies to provide reasonable assurance that it has met the three objectives of internal controls:

- *Operations*—Effectiveness and efficiency of operations;
- *Reporting*—Reliability of reporting for internal and external use; and
- *Compliance*—Compliance with applicable laws and regulations.

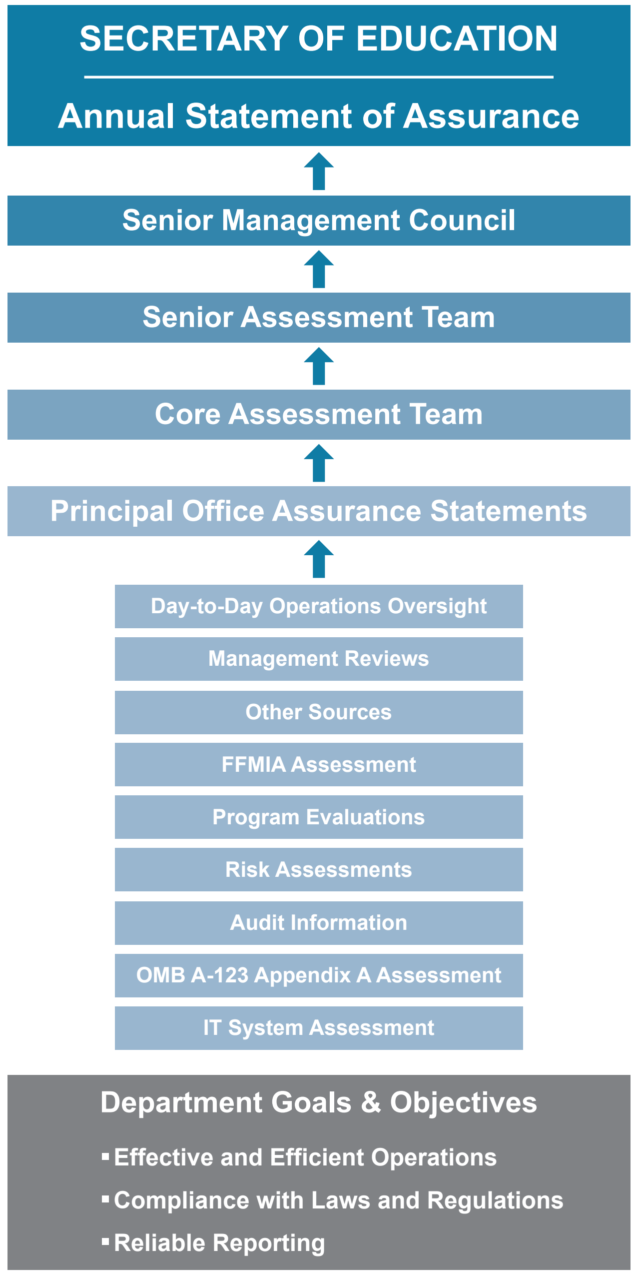
This section describes the Department's internal control framework, an analysis of the effectiveness of its internal controls, and assurances provided by the Department's leadership that internal controls were in place and working as intended during FY 2017 to meet the three objectives.

Control Framework

The Department's internal control framework helps to ensure that the Department achieves its strategic goals and objectives related to delivering education services effectively and efficiently while complying with applicable laws and regulations and preparing accurate reports. This includes providing reasonable assurance to Department leadership and external stakeholders that financial data produced by the Department's financial systems are complete, accurate, and reliable enough to support the preparation and fair presentation of financial statements that conform to federal standards, facilitate sound financial decision-making, and provide transparency about how the Department spent federal funds and maintains stewardship over its financial resources.

The Department maintains a comprehensive internal control framework and assurance process as depicted in the following diagram.

Figure 12. Internal Control Framework and Assurance Process



The Office of the Chief Financial Officer (OCFO) manages the assurance process on behalf of Department leadership. The Department established governance over the process, consisting of a Senior Management Council, a Senior Assessment Team (SAT), and a Core Assessment Team (CAT). The Senior Management Council is comprised of senior leaders from across the Department. It is the primary governance structure for internal control and provides oversight to ensure management accountability for effective controls across the Department. The SAT and CAT include representatives from OCFO, the Office of the Chief Information Officer (OCIO), student loan and grant-making program offices, Risk Management Service, and other operational support offices (including the Office of Management). The SAT and CAT provide greater oversight and monitoring of activities related to internal control assessments.

The annual assurance process is the primary mechanism by which the Department implements FMFIA and OMB requirements pertaining to internal control. It requires the head of each principal office to evaluate its respective internal controls and to assert, in a letter to the Chief Financial Officer, that it has reasonable assurance that key internal controls are in place and working as intended or to provide a detailed description of significant deficiencies, material weaknesses, and other matters of nonconformance. In making this assessment, the head of the principal office considers information such as office managers' personal knowledge of operations, external audit results, internal assessments, and other related material.

OCFO staff work with the principal offices to help them identify potential control deficiencies and consult with the SAT to determine whether they represent significant deficiencies or potential material weaknesses. Any principal office that identifies a significant deficiency or material weakness must prepare a Corrective Action Plan to address the issue. These Corrective Action Plans, in addition to daily operational oversight and management-initiated evaluations, facilitate the correction and monitoring of controls. If potential material weaknesses are identified, they are evaluated by the Senior Management Council to determine if they should be reported on the Department's Statement of Assurance.

Analysis of Controls

Overall, the Department relies on the principal office annual assurances, supported by risk-based internal control evaluations and testing, to provide reasonable assurance that its internal controls are well designed and in place and working as intended. The Department also considers issues identified by external auditors. During FY 2016, the Department revised its annual assurance process to conform to the new requirements contained in the revised U.S. Government Accountability Office publication, *Standards for Internal Control in the Federal Government* (commonly referred to as the "Green Book"). In FY 2017, the Department further revised the process to conform to the revised OMB Circular A-123 issued on July 15, 2016.

In FY 2017, the Department identified no material control weaknesses related to effective, efficient program operations and no areas of noncompliance with laws and regulations other than those noted in the Internal Control Exceptions section below. Although no material weaknesses were identified, the Department realizes that it has areas of control that need further strengthening, such as those disclosed in this report and the major challenges identified by the Department's OIG in its **OIG FY 2018 *Management Challenges* report**. The Department continues to demonstrate its commitment to addressing, mitigating, or resolving its identified management challenges.

In accordance with OMB Circular A-123, the Department also conducted an additional assessment of the effectiveness of the Department's internal controls over financial reporting and compliance with key financial management laws and regulations as described below.

Internal Control over Financial Reporting

The Department maintains strong internal controls to identify, document, and assess internal control over financial reporting, which includes:

- comprehensive process documentation for the Department's significant business processes' and subprocesses,
- maintenance of a control catalogue comprised of 3,631 key financial, operational, and IT controls that align to the business processes (the Department documents 312 key controls and FSA documents 3,319 key controls [1,411 Business Process and Entity-Level controls and 1,908 IT controls]),[1]
- technical assistance provided to principal offices to help them understand and assess key financial controls,
- a risk-based testing strategy, and
- a process to develop corrective action plans when control deficiencies are found and to track progress against those plans.

During FY 2017, the Department tested 84 key financial controls. Although some control deficiencies were detected in the design and effectiveness of controls, the Department did not identify any significant deficiencies or material weaknesses. Corrective actions have been initiated for the deficiencies identified.

In FY 2017, FSA tested 2,810 key controls: 1,342 Business Process and Entity-Level controls and 1,468 IT controls. FSA assessed that 96 percent of the controls tested are designed and operating effectively. The other 4 percent are immaterial deficiencies for which FSA has established or is establishing corrective actions. FSA will continue to repeat this assessment process on a regular basis, constantly looking for opportunities to improve operations.

Internal Control over Financial Management Systems

The FFMIA requires management to ensure that the Department's financial management systems consistently provide reliable data that comply with federal financial management system requirements, applicable federal accounting standards, and the U.S. Standard General Ledger at the transaction level. Appendix D to OMB Circular A-123, Compliance with the *Federal Financial Management Improvement Act* of 1996, and OMB Circular A-130, *Managing Federal Information as a Strategic Resource*, provide specific guidance to agency managers when assessing conformance to FFMIA requirements.

The Department's core financial systems are under the umbrella of the Education Central Automated Processing System (EDCAPS), serving approximately 8,800 Departmental internal users in Washington, D.C., and 10 regional offices throughout the United States, as well as 39,600 external users. EDCAPS is composed of five main linked components:

- Financial Management Support System (FMSS),
- Contracts and Purchasing Support System (CPSS),
- Grants Management System (G5),
- E2 Travel System, and
- Hyperion Budget Planning.

The Department designated the FMSS as a mission-critical system that provides core financial management services, and focused its system strategy on the following areas during FY 2017:

- Managing and implementing cross-validation rules throughout the fiscal year to prevent invalid accounting transactions from being processed,
- Transmitting the Department's spending data related to contracts, grants, loans, and other financial assistance awards for the **USASpending.gov** initiative as part of the *Federal Funding Accountability and Transparency Act of 2006*,
- Transmitting the Department's spending data related to contracts, grants, loans, and other financial assistance awards for the *Digital Accountability and Transparency Act of 2014* (DATA Act) implementation, and

[1] These figures include FSA.

- Initiating the upgrade of the FMSS Oracle E-Business Suite application to Oracle R12, to ensure continued vendor support, improved security, improved infrastructure and enhanced functionality.

In FY 2018, EDCAPS will continue to provide customer service and improve security of its systems by completing the Department's implementation of Oracle E-Business Suite R12. In doing so, the Department will be current and ready to provide a more secure and better integrated financial management application.

The Department's financial management systems are designed to support effective internal control and produce accurate, reliable, and timely financial data and information. Based on self-assessments, system-level general controls tests, and the results of internal and external audits, the Department has not identified any material weaknesses in controls over systems. The Department has also determined that its financial management systems substantially comply with FFMIA requirements. However, as noted below in the Internal Control Exceptions section, the Department continues to address issues and improve its controls over systems.

Federal Information Security Modernization Act of 2014

The *Federal Information Security Modernization Act of 2014* (FISMA) requires federal agencies to develop, document, and implement an agency wide program to provide security for the information and information systems that support the operations and assets of the agency and ensure the confidentiality, integrity, and availability of system-related information.

The Department's and FSA's information security programs completed a number of significant activities in FY 2016 and FY 2017 to improve cybersecurity capabilities and functions, some of which included:

- In March 2017, the Office of the Chief Information Officer (OCIO) initiated an Information Technology (IT) Systems Assessment process, designed to improve management of the Department's IT systems inventory by:
  - Reexamining/revising the IT systems baseline for both FISMA reportable and non-FISMA reportable IT systems,
  - Enhancing governance and security posture of the Department's IT systems portfolio, informing strategy to address externally hosted systems,
  - Establishing long/short term corrective action plans to address findings, and
  - Rationalizing the IT systems portfolio and inventory.
- The IT Systems Assessment process began with examining the 19 High Value Asset (HVA) systems within the Department. As of September 2017, the OCIO team had completed assessments for all 19 HVA systems.
- With the issuance by OMB of the federal government's Cybersecurity Strategy and Implementation Plan (CSIP), the Department focused many of its efforts to address the recommendations and actions highlighted in the CSIP in order to resolve any cybersecurity gaps and emerging priorities that were noted across the government. The CSIP required the Department to prioritize the identification and protection of high-value information and assets. The Department completed this action and re-validated its list of HVAs in January 2017, which will enable the Department to better understand the potential impact from a cyber incident, and helps to ensure that robust physical and cybersecurity protections are in place for our high-value assets. The Department completed development of its Cybersecurity Strategy and Implementation Plan (ED-CSIP) in February 2017, which includes the cybersecurity initiatives and activities that demonstrate how the Department is implementing the Cybersecurity Framework functions of Identify, Protect, Detect, Respond, and Recover.

- The Department continued to enhance the capabilities of the Department's Security Operations Centers (SOCs). The Department has fully deployed the Einstein capabilities in order to enhance our ability to detect cyber vulnerabilities and protect against cyber threats. The Department has also continued to strengthen its partnership with the Department of Homeland Security for the project planning that will accelerate the deployment of Continuous Diagnostics and Mitigation (CDM) capabilities. This will further enhance capabilities that the Department initiated in 2016 to implement network access control and data loss prevention (DLP) solutions. The DLP capability has been activated for the Department's primary network and is effectively detecting and preventing any inadvertent attempts by staff to send social security numbers via e-mail. The CDM solution will also enable the Department to enhance our configuration management capabilities.

- The Department continued its progress of implementing and enforcing the use of multifactor authentication for all federal employees, contractors, and other authorized users. The Department and FSA focused on increasing the issuance of Personal Identity Verification (PIV) cards to privileged users to meet OMB requirements. The Department has consistently reported each quarter achieving the Cross Agency Priority target requiring our users to be technically enforced to use their PIV cards when logging on to the network.

- The Department made significant strides in its identification, tracking, and remediation of unsupported software across the enterprise.

- 100 percent of Department users completed the annual computer security and privacy awareness training course in FY 2017. The Department strictly enforced compliance with annual security and privacy awareness training requirements, and disabled network accounts for noncompliant users.

- There has also been an increased Departmental focus on data security at institutions of higher education (IHEs). FSA issued a new "Dear Colleague Letter" to IHEs that receive financial aid stressing the need to comply with the *Gramm-Leach-Bliley-Act* standards and announcing that these standards would now be included in future reviews to be conducted by the Department. The Department recognizes that it is vital to focus on cybersecurity at these IHEs as they connect to FSA systems and access FSA data. It is noteworthy that the Department has successfully implemented two-factor authentication for all external users of the G5 system, which is a customer-facing grants management system. The Department has also engaged the General Services Administration and we have signed a memorandum of understanding to implement a pilot for the use of Login.gov for two-factor authentication to other Department citizen-facing information systems.

As a result of the Department implementing a comprehensive set of activities to strengthen the overall cybersecurity of the Department's networks, systems, and data, the Department completed actions to close 10 of the 15 recommendations to address the 11 findings made by the OIG in its FY 2016 annual FISMA audit. For the FY 2017 annual FISMA audit, the OIG is reporting 37 recommendations covering the seven FISMA metrics domains.

The OIG FISMA Audit objective was to conduct annual independent evaluations and tests to determine the effectiveness of the information security program policies, procedures, and practices of the Department and Federal Student Aid (FSA). The FY 2017 OIG FISMA reporting metrics were organized around the five security functions outlined in the National Institute of Standards and Technology's "Framework for Improving Critical Infrastructure Cybersecurity (Cybersecurity Framework): Identify, Protect, Detect, Respond, and Recover." The FY 2017 maturity model was more comprehensive and attributes were assessed differently than the previous year's maturity model indicator scoring. As a result, certain functions were assessed at a lower level, and the OIG found the Department and FSA were not effective in all five security functions.

INTERNAL CONTROL EXCEPTIONS

The Department identified two instances of noncompliance with laws and regulations in FY 2017. Additionally, reviews and assessments conducted pursuant to information technology-related laws and regulations identified challenges still facing the Department.

IMPROPER PAYMENTS INFORMATION ACT OF 2002

The *Improper Payments Information Act of 2002* (IPIA), **Pub. L. 107-300, 116 Stat. 2350**, as amended by the *Improper Payments Elimination and Recovery Act of 2010* (IPERA), **Pub. L. 111-204, 124 Stat. 2224**, and the *Improper Payments Elimination and Recovery Improvement Act of 2012* (IPERIA), **Pub. L. 112-248, 126 Stat. 2390**, require federal agencies to annually report improper payments for programs that are deemed susceptible to significant improper payments. IPERA also requires each agency's Office of Inspector General (OIG) to review the agency's improper payment reporting in its AFR and accompanying materials, and to determine whether the agency has met six compliance requirements.

In its annual improper payment compliance audit for FY 2016, the OIG concluded that the Department was not compliant with IPERA because it did not meet two of IPERA's six compliance requirements. The Department reported improper payment rates for the Direct Loan and Pell Grant (Pell) programs that did not meet the FY 2016 reduction targets and the Department's risk assessments for its grant programs managed by offices other than Federal Student Aid (FSA) and contracting activities managed by FSA did not conform to applicable guidance.

This determination of noncompliance with IPERA does not represent a material weakness in the Department's internal controls.

DEBT COLLECTION IMPROVEMENT ACT OF 1996

The *Debt Collection Improvement Act of 1996* (DCIA), **Pub. L. 104-134, 110 Stat. 1321-358**, was enacted into law as part of the *Omnibus Consolidated Rescissions and Appropriations Act of 1996*, **Pub. L. 104-134, 110 Stat. 1321**. The primary purpose of the DCIA is to increase the collection of nontax debts owed to the federal government. Additionally, the DATA Act, **Pub. L. 113-101, 128 Stat. 1146**, amended Section 3716(c)(6) of the DCIA to require referral of delinquent debt to Treasury's Offset Program within 120 days.

Due to unique program requirements of HEA, the Department requested guidance from Treasury's Bureau of Fiscal Service, Office of General Counsel for the application of this revised DCIA requirement to Title IV debt. Treasury provided its interpretation of this requirement for Title IV debt in July 2015. As of September 30, 2017, the Department and FSA were not in compliance with the new 120-day referral requirement in 31 U.S.C. Section 3716(c)(6) because FSA had not yet revised its loan servicing systems, procedures, and internal processes in response to this interpretation. During FY 2017, FSA initiated the change management process for its default loan servicer to refer eligible debts to the Treasury Offset Program sooner, developed DCIA compliant referral exclusions, and continued to identify policy changes required to work towards achieving compliance. This area of noncompliance is noted in the independent auditors' report, exhibit B.

This determination of noncompliance with the DCIA does not represent a material weakness in the Department's internal controls.