# REPORT OF THE INDEPENDENT AUDITORS

**UNITED STATES DEPARTMENT OF EDUCATION**
**OFFICE OF INSPECTOR GENERAL**

THE INSPECTOR GENERAL

November 15, 2018

The Honorable Betsy DeVos
Secretary of Education
Washington, D.C. 20202

Dear Secretary DeVos:

The enclosed report presents the results of the audit of the U.S. Department of Education's (Department) financial statements for fiscal year 2018 to comply with the Chief Financial Officers Act of 1990, as amended. The report 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 KPMG LLP to audit the financial statements of the Department as of September 30, 2018, 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**

KPMG found:

- The fiscal year 2018 financial statements are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America;
- One material weakness in internal control over financial reporting:
    - Controls over the Reliability of Information Used in the Modeling Activities Need Improvement;
- One significant deficiency in internal control over financial reporting:
    - Information Technology Controls Need Improvement; and
- One instance of reportable noncompliance with Federal law related to referring delinquent student loan debts to Treasury.

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KPMG is responsible for the attached auditors' report dated November 15, 2018, and the conclusions expressed therein. We do not express opinions on FSA's financial statements or internal control over financial reporting, or conclusions on compliance and other matters.

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

Sincerely,

Kathleen S. Tighe
Inspector General

Enclosure

KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

**Independent Auditors' Report**

Inspector General
United States Department of Education

Secretary
United States Department of Education:

**Report on the Financial Statements**

We have audited the accompanying consolidated financial statements of the United States Department of Education (Department), which comprise the consolidated balance sheet as of September 30, 2018, and the related consolidated statements of net cost, and changes in net position, and combined statement of budgetary resources for the year then ended, and the related notes to the consolidated financial statements.

*Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

*Auditors' Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and in accordance with Office of Management and Budget (OMB) Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 19-01 require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated financial statements.

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

KPMG

*Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the United States Department of Education as of September 30, 2018, and its net cost, changes in net position, and budgetary resources for the year then ended in accordance with U.S. generally accepted accounting principles.

*Other Matters*

Accompanying Prior Period Financial Statements

The accompanying consolidated financial statements of the Department as of September 30, 2017 and for the year then ended were audited by other auditors whose report thereon dated November 13, 2017 expressed an unmodified opinion on those financial statements before the reclassifications described in Note 1 to the consolidated financial statements. As described in Note 1, to conform to fiscal year 2018 financial reporting requirements contained in OMB Circular A-136, *Financial Reporting Requirements*, the Department made the following reclassifications to the fiscal year 2017 consolidated financial statements and notes:

- The Combined Statement of Budgetary Resources was condensed to present budgetary resources, status of budgetary resources, and net outlays, while removing the presentation of the change in obligated balance.
- Note 6, Liabilities Not Covered by Budgetary Resources, was expanded to include the presentation of liabilities not requiring budgetary resources.

As part of our audit of the 2018 consolidated financial statements, we also audited the reclassifications described in Note 1 that were applied to reclassify the 2017 consolidated financial statements. In our opinion, such reclassifications are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 2017 consolidated financial statements of the Department other than with respect to the reclassifications and, accordingly, we do not express an opinion or any other form of assurance on the 2017 consolidated financial statements as a whole.

Interactive Data

Management has elected to reference to information on websites or other forms of interactive data outside the *Agency Financial Report* to provide additional information for the users of its financial statements. Such information is not a required part of the basic consolidated financial statements or supplementary information required by the Federal Accounting Standards Advisory Board. The information on these websites or the other interactive data has not been subjected to any of our auditing procedures, and accordingly we do not express an opinion or provide any assurance on it.

Required Supplementary Information

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

Other Information

Our audit was conducted for the purpose of forming an opinion on the basic consolidated financial statements as a whole. The information on pages i through iii, Message from the Secretary, information on pages 28 and 29, Other Information Section, and Appendices are presented for purposes of additional analysis and are not a required part of the basic consolidated financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

**Other Reporting Required by *Government Auditing Standards***

*Internal Control over Financial Reporting*

In planning and performing our audit of the consolidated financial statements as of and for the year ended September 30, 2018, 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 consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

Our consideration of internal control was for the limited purpose described in the preceding paragraph 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 have not been identified. However, as described in the accompanying exhibits, we did identify certain deficiencies in internal control that we consider to be a material weakness and a significant deficiency.

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 entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiencies described in Exhibit A, *Controls over the Reliability of Information Used in the Modeling Activities Need Improvement*, to be a material weakness.

Department management did not report the material weakness, *Controls over the Reliability of Information Used in the Modeling Activities Need Improvement*, in its *Statement of Assurance*, included in the Management's Discussion and Analysis section of the accompanying *Agency Financial Report*.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in Exhibit B, *Information Technology Controls Need Improvement,* to be a significant deficiency.

*Compliance and Other Matters*

As part of obtaining reasonable assurance about whether the Department's consolidated financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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 disclosed an instance of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 19-01, and which is described in Exhibit C, *Requirement for Referring Delinquent Student Loan Debts to Treasury*.

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We also performed tests of its compliance with certain provisions referred to in Section 803(a) of the *Federal Financial Management Improvement Act of 1996* (FFMIA). Providing an opinion on compliance with FFMIA was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances in which the Department's financial management systems did not substantially comply with the (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level.

*The Department's Responses to Findings*

The Department's responses to the findings identified in our audit are described in Exhibit D. The Department's responses were not subjected to the auditing procedures applied in the audit of the consolidated financial statements and, accordingly, we express no opinion on the responses.

*Purpose of the Other Reporting Required by Government Auditing Standards*

The purpose of the communication described in the Other Reporting Required by *Government Auditing Standards* section is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Department's internal control or compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Washington, D.C.
November 15, 2018

**Exhibit A**

***Material Weakness***

**Controls over the Reliability of Information Used in the Modeling Activities Need Improvement**

Under the *Federal Credit Reform Act of 1990* (FCRA), the Department of Education (the Department) is required to perform periodic interest rate and technical re-estimates of the subsidy costs of its direct loan and guaranty programs. These re-estimates are calculated using an internally-developed cash flow model performed by the Department's Cost Estimation and Analysis Division (CEAD). The cash flow model utilizes assumptions based on sourced data elements from the National Student Loan Data System (NSLDS) that are updated at different intervals by third parties (servicers, guaranty agencies, etc.) and certain assumptions provided by the Office of Management and Budget (OMB). These future cash flow outputs generated from the Department's Student Loan Model (SLM) are then input into OMB's Credit Subsidy Calculator (CSC), as required by U.S. generally accepted accounting principles to generate subsidy re-estimates.

**Conditions:**

*Credit Reform Student Loan Model Documentation and Analysis*

We noted that management's documentation detailing the models currently in use including methodologies and/or considerations used to calculate the assumptions could be improved. Such improvements could provide sufficient details to enable an independent reviewer to effectively assess the reasonableness of key decisions made regarding critical elements of the re-estimate computations and the potential impact on the financial statements. We also noted that management's analysis of the reestimate results identified material differences which are expected to reverse over time, however such analysis was not clearly documented to support management's consideration of the effect of such differences, if any, on the fair presentation of direct loans in accordance with accounting standards. We found the following areas where specific documentation could be improved:

- CEAD produces a model inventory which includes all model assumptions, however it does not specify which assumptions are key. The model inventory includes summarized information on inputs supporting the assumptions, however it does not identify the specific data elements related to each input;
- CEAD's sensitivity analysis should be expanded to include a documented evaluation of which assumptions are key to the estimation model; and
- CEAD's management review controls should be documented at a sufficient level of detail to demonstrate the level of precision used in management's analysis and the evaluation of estimation uncertainty on the fair presentation of the financial statements and related footnotes in accordance with accounting standards.

*Controls over the Completeness and Accuracy of Data Elements used in the Student Loan Model*

The assumptions used in SLM are developed by utilizing certain data elements of direct and guaranty loans extracted from the NSLDS such as loan identifier, loan type, origination date, net amount disbursed, and repayment plan type, among many others.

We noted that management's processes, procedures, and controls should be improved to provide sufficient detail over procedures and controls that specifically address the evaluation of the completeness and accuracy of data elements from NSLDS used to develop model assumptions.

*NSLDS Oversight of Loan Guaranty Balances*

Under the Federal Family Education Loan (FFEL) guaranty loan program, private lenders provide federally guaranteed student loans to parents and students. The FFEL program began in 1965 and ran until 2010. Student loan data from schools, guaranty agencies, the direct loan program, and other Department programs are stored in the NSLDS.

Financial institutions, servicers, and guaranty agencies have up to 90 days after year-end to report guaranteed loan data to NSLDS. Therefore, such information may not be updated until December 31 each year. To determine the balance of loan guarantees at the end of each fiscal year, the Department executes a query in NSLDS in October. The Department utilizes this information sourced from NSLDS to develop financial statement note disclosures related to the performing FFEL program guaranty loans, including the principal balance outstanding and maximum government exposure. In addition, the exposure information is used in the estimation methodology related to the liability for loan guarantees.

We noted that management did not design and implement effective controls to ensure that the NSLDS query extracts related to the total exposure amount for loan guarantees with private lenders were complete and accurate. For example, specific controls over the completeness and accuracy of these queries, including how timing differences are resolved, were not evidenced in management's internal control processes.

**Cause/Effect:**

The Department's documentation was not at a sufficient level of detail to enable an independent reviewer to properly assess the reasonableness of management's reestimate modeling practices to include processes; specific controls; information used; and key judgments determined by management as part of the reestimate methodologies utilized for financial reporting purposes. We noted that while there are controls related to the accounting and reporting of loan programs, such controls are not designed at a sufficient level of precision to demonstrate the assessment and evaluation of the completeness and accuracy of data used in the SLM assumptions and relevant financial statement disclosures.

The reestimate processes and controls at the Department form an integral part of the financial reporting process, which impact the most significant estimates and related balances in the financial statements and related footnotes. As a result, weaknesses in processes, procedures, and controls in the areas described above impact management's ability to prevent, detect, and correct errors in the re-estimate process, which could lead to a material misstatement of the financial statements.

**Criteria:**

The following criteria were considered in the evaluation of the material weakness presented in this exhibit:

- *Green Book* (GAO-14-704G – Federal Internal Control Standards), Section OV3.05, Section OV4.08, Principle 10.03, Section 12.03, Section 13.04
- FASAB Technical Release 6, *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act – Amendments to Technical Release No. 3 Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reforms Act*, Paragraphs 17, 20, 23, 27, 38 and 40
- SFFAS 2, *Accounting for Direct Loans and Loan Guarantees*, Paragraphs 22 and 23

**Recommendations:**

1. With respect to the SLM documentation and analysis, we recommend that the Department management:

    a. Coordinate among the various groups at the FSA and CEAD to determine, each year, what key assumptions and data elements will be used in the Credit Reform re-estimate calculations. These determinations should be fully documented to enable a reviewer to understand and re-perform procedures, as needed.

2. With respect to model estimation uncertainty, we recommend that the Department and FSA management:

    a. Ensure that sufficient documentation is maintained evidencing management's analysis and consideration of the effects of model estimation uncertainty on the fair presentation of the financial statements and related note disclosure reestimates in accordance with accounting standards.

3. With respect to the completeness and accuracy of the data elements used in the SLM, we recommend that the Department management:

    a. Work with FSA to validate that appropriate data elements are extracted from NSLDS.

4. We recommend that the FSA management:

    a. Enhance existing documentation and controls to demonstrate the relationship between the key data elements used in the estimation model assumptions and the controls over student loan transactions at FSA.

5. With respect to the NSLDS oversight of loan guaranty balances, we recommend that the Department and FSA management:

    a. Develop, implement, and document controls to assess the reasonableness of the principal balance outstanding and maximum government exposure amounts presented in the financial statement footnotes and used in calculating the liability for loan guarantees.

    b. Enhance the query process documentation to demonstrate the completeness and accuracy of the NSLDS query for the performing FFEL loan principal balance outstanding and maximum government exposure.

    c. Develop, implement, and document a sensitivity analysis related to NSLDS queries of September 30 balances considering the potential timing differences in the data being used for financial reporting.

**Exhibit B**

***Significant Deficiency***

**Information Technology Controls Need Improvement**

**Condition:**

During fiscal year 2018, we noted information technology (IT) control deficiencies related to logical access in the Department's network and in one application system managed by the Department and access and change control in two application systems managed by the FSA, as follows:

- Weaknesses in the Department's IT controls related to the removal of separated users' access from the network and one of its applications;
- Weaknesses in FSA's IT controls related to the review and recertification of system access. Specifically, the access reviews did not cover all users for one of the FSA systems. Additionally, for two FSA systems, the access lists provided by the contractors to perform the periodic access reviews were not verified for completeness and accuracy; and
- Weaknesses in FSA's IT controls related to the segregation of duties. For example, in one FSA system, the developers retained greater than read-only access to the application in the production environment.

Additionally, we noted weaknesses related to program development, where evidence of data validation upon system migration to a new data center was not available.

Additionally, in FY 2017, the predecessor auditor reported a significant deficiency related to the Department and FSA internal control environments due to persistent unmitigated IT control deficiencies. During FY 2018, the Department and FSA management demonstrated progress addressing some of these long-standing deficiencies. However, management has not fully remediated prior year weaknesses related to logical access administration, user access removal, user access reviews, and recertification and system configuration management. Due to the nature of these control deficiencies, the Department and FSA management continue to implement corrective actions to remediate these control deficiencies. The continued existence of these deficiencies reduces managements' ability to effectively manage information system risks.

**Cause/Effect:**

These IT control deficiencies existed because (1) the Department and FSA did not consistently adhere to its documented agency-wide policies and procedures and NIST requirements consistently for systems hosted and managed by the Department and FSA or by service organizations; (2) certain Department and FSA policies and procedures did not require the documentation and maintenance of supporting control documentation and review of evidence; and (3) the Department and FSA did not fully implement their corrective actions to remediate prior-year conditions and associated causes. Furthermore, separated user access deficiencies resulted due to the lack of timely notification of user separations by internal departments.

Ineffective IT controls increases the risk of unauthorized use, disclosure, disruption, modification, or destruction of information and information systems that could impact the integrity and reliability of information processed in the associated applications which may lead to misstatements of the financial statements.

**Criteria:**

The following criteria were considered in the evaluation of the significant deficiency presented in this exhibit:

- The Departmental Directive OM 3-104, *Clearance of Personnel for Separation or Transfer*
- National Institute of Standards and Technology Special Publication 800-53 Revision 4, dated April 2013, *AC-2 Account Management, AC-5 Separation of Duties, AC-6 Least Privilege, CM-3 Configuration Change Control*

- Federal Information Processing Standards 200, *Minimum Security Requirements for Federal Information and Information systems*
- The *Standards for Internal Control in the Federal Government,* issued by the Comptroller General of the United States, Principle No. 7, *Identify, Analyze, and Respond to Risks,* Principle No. 11, *Design Activities for the Information System,* and Principle No. 13, *Use Quality Information*
- Appendix III to OMB Circular No. A-130, Section 4, Specific Requirements, *I. Specific Safeguarding Measures to Reinforce the Protection of Federal Information and Information Systems*

**Recommendations:**

We recommend that the Department and FSA management:

1. Perform comprehensive user access reviews and re-certifications, and confirm the access lists received for review by designated management are complete and accurate prior to commencing the review.

2. Implement mechanisms and procedures to require timely notification of user separations and subsequent disabling of access.

3. Establish requirements for formal documentation of data validation following data migration for systems.

4. Prevent or limit developer access in the production environment to read-only.

**Exhibit C**

***Compliance Matter***

**Requirement for Referring Delinquent Student Loan Debts to Treasury**

In 2014, Federal Law (31 U.S. Code Section 3716(c) (6)) was amended (Public Law 113-101 (*DATA Act*) Section 5) to require agencies to notify the Secretary of the Treasury of valid, delinquent nontax debts that are over 120 days delinquent – 60 days earlier than the previous 180 days requirement – for the purpose of administrative offset (i.e., collection through the reduction of future Federal payments). Due to the number of entities and systems involved in handling student loan debts and the decentralized nature of such processes, FSA is not yet capable of meeting this accelerated timeline. Accordingly, as of September 30, 2018, the Department and FSA are not in compliance with the requirement to refer student debt delinquent for 120 days to the Department of the Treasury.

To meet this requirement, the Department obtained legal clarification of how certain specific requirements of the amended law apply to the Direct Loan Program and other Department programs, and are improving delinquent debt reporting procedures, increasing the frequency of some debt referrals, and modifying its defaulted loan management system to accommodate this change. The Department is also evaluating the impact of defining defaulted loans earlier in schools' performance reporting and has developed a long-term project plan to incorporate the new referral requirements into various servicer contracts and guaranty agency agreements, so it can initiate the required system programming changes. FSA is also working with the Department in evaluating certain options for other requirements needed to achieve compliance.

**Recommendation:**

We recommend that the Department continue to execute the corrective actions as outlined in FSA's project plan to comply with the timing requirement for the referral of delinquent non-tax debts.

***Management's Response*** **Exhibit D**

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF THE CHIEF FINANCIAL OFFICER

MEMORANDUM

NOV 1 4 2018

TO: Kathleen S. Tighe
Inspector General

FROM: Larry Kean
Director, Budget Service Delegated
the Duties of Chief Financial Officer

Jason Gray
Chief Information Officer

SUBJECT: DRAFT INDEPENDENT AUDITORS' REPORT
Fiscal Year 2018 Financial Statements
U.S. Department of Education
ED-OIG/A17S0001

Please convey the Department's sincere thanks to everyone on your staff who worked diligently on this financial statement audit. The Department reviewed the draft Fiscal Year 2018 Financial Statement Audit Report. We concur and agree with the Independent Auditors' Report, including the Opinion on the Financial Statements, Report on Internal Control over Financial Reporting, and Report on Compliance and Other Matters.

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 and Acting Deputy Chief Financial Officer, at (202) 245-8118 with any questions or comments.

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www.ed.gov

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