STATUS OF FINANCIAL MANAGEMENT AT THE U.S. DEPARTMENT OF EDUCATION

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT EDUCATION

OF THE

COMMITTEE ON EDUCATION AND THE WORKFORCE

HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

HEARING HELD IN WASHINGTON, DC, APRIL 10, 2002

Serial No. 107-56

Printed for the use of the Committee on Education and the Workforce

82-131 pdf

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HEARING ON

THE STATUS OF FINANCIAL MANAGEMENT AT

THE U.S. DEPARTMENT OF EDUCATION

WEDNESDAY, APRIL 10, 2002

U.S. HOUSE OF REPRESENTATIVES,

SUBCOMMITTEE ON SELECT EDUCATION,

COMMITTEE ON EDUCATION AND THE WORKFORCE,

WASHINGTON, D.C.

The subcommittee met, pursuant to notice, at 2:03 p.m. in Room 2175, Rayburn House Office Building, Hon. Peter Hoekstra [chairman of the subcommittee], presiding.

Present: Representatives Hoekstra, Tiberi, Schaffer, Roemer, Holt, and Davis.

Staff Present: Cindy Herrle, Senior Budget Analyst; Patrick Lyden, Professional Staff Member; Stephanie Milburn, Professional Staff Member; Deborah Samantar, Committee Clerk/Intern Coordinator; Holli Traud, Legislative Assistant; Heather Valentine, Press Secretary; James Kvaal, Minority Legislative Associate/Education; Maggie McDow, Minority

Legislative Associate/Education; and Joe Novotny, Minority Staff Assistant/Labor.

OPENING STATEMENT OF CHAIRMAN PETER HOEKSTRA, SUBCOMMITTEE ON SELECT EDUCATION, COMMITTEE ON EDUCATION AND THE WORKFORCE, U.S. HOUSE OF REPRESENTATIVES, WASHINGTON, D.C.

Chairman Hoekstra. A quorum being present, the Subcommittee on Select Education will come to order.

We are meeting today to hear testimony on the status of the financial management of the Department of Education. Under Rule 12(b), opening statements are limited to the chairman and the ranking minority member of the subcommittee. Therefore, if other members have statements, they may be included in the hearing record.

With that, I also ask unanimous consent for the hearing record to remain open 14 days to allow members' statements and other extraneous material reference during the hearing to be submitted in the official record.

Without objection, so ordered.

Welcome back. I think you have all been here before. I was going to say, Bill, it might be your first time in this capacity. It's your second time. This is the sixth in what has become a series of hearings that we have held to examine the department's financial management practices.

We must be making progress, shown by the interest of our colleagues here today. It is not quite as an exciting hearing or content as what we would have thought in the past, but I think that is one of the reasons we have made some progress.

I believe we are going to have encouraging testimony from each of our witnesses which will highlight some of the problems and the issues that we have had in the past, but that, in many of those areas, we have either addressed the issues or we have made significant progress which is leading us to the hope and the expectation that within the near future, we will be able to move forward and, in tandem, be working on policy changes and have the basic foundation in place for a solid financial and management control systems within the Department of Education.

I thank each of you for the contributions that you have made in enabling us to make that progress and to get to those steps.

I am especially encouraged by the commitment made by the Secretary of Education, Secretary Paige, in making this a priority and making it one of his key measurements as he goes about implementing an agenda at the Department of Education.

I think that the focus, commitment and recognition that if he didn't, he would be up here on a regular basis, with us asking the question why. However, he realized that that needed to be one of his commitments, and I think it comes from his past professional experience heading up a large urban school district, where accountability and financial management were an essential part.

So I he came there and we are thankful for that type of leadership and the team that he has put in place. We are especially appreciative of the help of GAO in helping establish some guidelines and some benchmarks and those types of things to kind of lead us and identify what the problems, what the issues were, and some of the things that might need to be done to correct those.

Ms. Lewis, we are especially appreciative of the Inspector General's office. You have had a lot of work over the last few years. Your staff this morning gave us, I think the good news is, that a number of cases have been closed.

There have been a number of convictions, and the bad news is that we had to go through that process, but it appears that in working with the Justice Department, the message has been received that the Justice Department and the Inspector General's office are going to hold the people within the Education Department accountable for their performance and the resources that are

entrusted to them by the American people.

So I think the combination of the leadership within the department, the IG's office, and then the contributions by GAO has enabled us to make the progress that we have made to date.

So thanks to each of you and I will be looking forward to hearing the progress reports from each of you.

With that, I will yield to my ranking member, Mr. Roemer.

OPENING STATEMENT OF CHAIRMAN PETER HOEKSTRA, SUBCOMMITTEE ON SELECT EDUCATION, COMMITTEE ON EDUCATION AND THE WORKFORCE, U.S. HOUSE OF REPRESENTATIVES, WASHINGTON, D.C. – SEE APPENDIX A

OPENING STATEMENT OF RANKING MINORITY MEMBER TIM ROEMER, SUBCOMMITTEE ON SELECT EDUCATION, COMMITTEE ON EDUCATION AND THE WORKFORCE, U.S. HOUSE OF REPRESENTATIVES, WASHINGTON, D.C.

Mr. Roemer. Thank you, Mr. Chairman. I ask unanimous consent that my entire statement be entered in the record.

Chairman Hoekstra. Without objection, so ordered.

Mr. Roemer. Thank you, Mr. Chairman. Mr. Chairman, I will be brief in reading the statement. I do want to welcome our witnesses before us, some which have testified two times, some probably a half-dozen times.

Mr. Chairman, like you, I am very interested in ensuring that our tax dollars are being used wisely and that the Department of Education's financial management practices are sound.

This is the sixth hearing that we have had on this in the last two years and I look forward to the day when these hearings are no longer necessary.

I want to congratulate the department for working towards obtaining a clean audit and I hope that next year it will indeed be a reality.

This was started by the Bush administration, the first Bush administration, almost 14 years ago. Then Richard Riley and the Clinton administration took over and Deputy Secretary David Kearns was in the early stages of making more needed changes. Secretary Riley made improving financial management a high priority during his time as Secretary, and I am glad to see that Secretary Paige shares this same level of commitment, and I am glad to see that President Bush

makes this a priority.

The Clinton administration was committed to working towards a clean audit and ridding the Department of Education of fraud and abuse. I am pleased with some of the positive steps that have been taken.

The cohort default rate on student loans has declined for seven consecutive years and was at a record low 6.9 percent at the beginning of this year. Collections on defaulted loans have more than doubled from one billion in Fiscal Year 1993 to over $3 billion in Fiscal Year 1999.

Data improvement in the national student loan data system has prevented the disbursement of as much as one billion in grants to ineligible students. But still more problems remain.

Mr. Hansen, I look forward to hearing about the improvements that you and Secretary Paige have made so far. I hope that soon these financial management problems will be behind you, too, so that you are freed up to work on important education policy areas, such as the Individuals with Disabilities Act.

Mr. Chairman, thank you again for holding another hearing on this topic, and I look forward to the day when, no offense intended, we don't see you before us six times in two years.

Thank you very much.

OPENING STATEMENT OF RANKING MINORITY MEMBER TIM ROEMER, SUBCOMMITTEE ON SELECT EDUCATION, COMMITTEE ON EDUCATION AND THE WORKFORCE, U.S. HOUSE OF REPRESENTATIVES, WASHINGTON, D.C. – SEE APPENDIX B

Chairman Hoekstra. Thank you, Mr. Roemer. Again, we have done this in a bipartisan way, in trying to move and help the department move forward.

Let me introduce the witnesses, and then we have to go vote. But there is only one vote, so we will be back relatively quickly.

We have with us again today Deputy Secretary Bill Hansen, the Chief Operating Officer and the Principal Advisor to Secretary Paige on Programs, Policies, Management, and Budget Matters.

There is a whole series of other things that Mr. Hansen has done prior to joining the Education Department, which I will omit, that I am impressed by, but, Bill, it's good to have you back.

We have Ms. Linda Calbom. She is the Director of the Division of Financial Management and Assurance at the General Accounting Office. Linda, you have been here frequently. We are

glad to have you back.

She is responsible for GAO's financial management work at many Federal agencies, including HHS, SSA, Education, DOE, USDA, HUD, Transportation, Interior, and SBA, a certified public accountant and certified government financial manager. Welcome back.

And we have Ms. Lorraine Lewis, the Inspector General of the U.S. Department of Education, has also served as General Counsel at the Office of Personnel Management and with the U.S. Senate Governmental Affairs Committee as General Counsel, Counsel, and Assistant Counsel, a Bachelor's degree from Yale University and a juris doctorate degree from Harvard.

So welcome to you and we will hear your testimony as soon as we get back. That will be about five to seven minutes, I would think. Thank you.

[Recess.]

Chairman Hoekstra. I think we're ready, Bill, to get started.

STATEMENT OF WILLIAM D. HANSEN, DEPUTY SECRETARY, U.S. DEPARTMENT OF EDUCATION, WASHINGTON, D.C.

Mr. Hansen. Thank you, Mr. Chairman and members of the subcommittee. It is a pleasure to be here again and also appreciate the comments that you made in introducing the work that we have been about, and appreciate the leadership that the subcommittee has provided to us, as well as the work of our Inspector General and GAO, in helping us identify the issues that we need to be improving upon.

When I testified in July of last year, I reported that our immediate task was getting our arms around the longstanding management problems.

We first had to identify where our weaknesses actually existed, and we did identify 661 outstanding audit improvement recommendations, and we have worked very aggressively to implement corrective actions and to close out each and every one of these recommendations, which I am pleased to say is done.

Moreover, we have identified an additional 93 audit recommendations since July and have either implemented or developed a corrective action plan for each of them, as well.

We will continue to work closely with both the Inspector General and GAO to make sure that we address any lingering management concerns and any new issues that will be arising as we proceed into the future.

Our next task was outlined in October, when Secretary Paige and I released our Blueprint for Management Excellence, which contained 140 concrete action improvement recommendations targeted toward addressing the longer term and structural issues that hinder efficient and effective

performance.

Since then, we have added 36 new action recommendations. These additional items are aligned with the President's management agenda, which was released last fall and part of the budget that was submitted in February, as well as the department's strategic plan, which was just released a couple of weeks ago.

Since October, we have completed approximately 15 percent of these action items and are making significant progress toward completing the others.

Our blueprint establishes a road map to realize further improvements and create mechanisms for achieving accountability and high performance throughout the department.

These positive results were a direct result, also, of the creation of our Executive Management Council, which I chair. This council represents pretty much our Board of Directors in the Department of Education, with about four or five senior career individuals and four or five political leaders that comprise the council.

I am also pleased to say that OMB agrees with our aggressive management approach, as it is aligned with the President's management agenda. In fact, they recently opined that, and this is a quote, ``Ed has developed robust plans to address longstanding problems pertaining to financial management, high-risk in student financial aid programs, and IT security."

The plans, of course, are not, by themselves, sufficient to ensure success. We must continually monitor their implementation, make adjustments as needed, and devote the necessary resources to ensure that we continue to improve performance and successfully address any lingering problems we have not yet overcome. Simply put, we just have to do it. We are also working in a public-private partnership. In accordance with the President's management agenda, the department plans to publish a five-year human capital, strategic sourcing, and restructuring plan in June of this year.

Employee teams are formulating plans, working with the advice and assistance of the National Academy of Public Administration, the Private Sector Council, and the Council for Excellence in Government.

The restructuring plan will address issues like maximizing workforce performance, improving efficiencies in citizen access to our programs, and finding the right blend of department employees and contractors to facilitate financial integrity and appropriate oversight of our programs.

Our accountability team, I also testified in July that our biggest challenge was developing a culture that emphasized individual responsibility and accountability.

In December, a team of employees from across the department completed a set of specific actions with assigned ownership, clear timetables, and performance measures that will establish a

mature culture of accountability within our agency.

These employees developed these actions based upon ideas and feedback obtained from our fellow colleagues across the department.

We are also implementing a new appraisal process that emphasizes accountability. Every senior officer, including myself, will sign a performance contract with Secretary Paige, holding us accountable for results. Every manager and employee will also have a performance agreement that reflects our goals and objectives and establishes clear individual job performance expectations.

On our financial statements, we recently received a qualified opinion from our 2001 financial statement audit. The results included one material weakness and three reportable conditions. These results reflect noticeable improvement and significant process from last year's three material weaknesses and two reportable conditions.

We are making steady progress toward our stated goal of obtaining our clean audit in fiscal year 2002.

We did receive this qualified opinion for two primary reasons. First, we provided insufficient evidence to support our general ledger balance adjustments, and, secondly, we did not provide adequate documentation to support certain amounts in our consolidated balance sheets.

We made these adjustments to compensate for continued financial system and reporting weaknesses during previous fiscal years. Although we have improved our account analysis and reconciliation processes, our auditor did not feel that there was sufficient documentation to support the accuracy or completeness of our corrections.

We have taken major steps to remedy our last material weakness by implementing a new general ledger system, the Oracle Federal Financials, on January 22 of this year. We expect our new accounting system to correct many deficiencies that resulted primarily from the lack of a fully integrated financial management system.

This improves our chances of getting a clean audit in 2002 and will allow our managers to obtain timely information they can use to make more productive program decisions.

We are currently reviewing our business procedures to ensure the integrity of our internal controls, reconciliation processes, and account analysis procedures to take advantage of the new system's capabilities.

Once the system and accounting processes are stabilized, we can fully address any remaining problems with our older underlying data. I believe we will accomplish our goal in getting a clean audit, but we still have much work to be done and a clean audit is actually a good goal, but we want to make sure that we've got the right systems in place to effectively manage our programs.

Mr. Chairman, if I could just take one additional minute to mention our internal control issues in responding to some of the issues that GAO has highlighted.

On the issue of inventory, we are continuing to re-engineer our asset management process to implement proper internal controls. To improve our asset management policies and procedures, we are centralizing inventory responsibility within our Office of Management, and documenting our detailed property management procedures.

We are also incorporating contractor recommendations into our property management procedures. We expect to issue these new policies and procedures in June 2002 and will hold our employees accountable for following them.

We are also addressing specific issues that GAO raised, including recording our inventory when initially purchased and appropriately securing and accounting for any items once they are received.

We are increasing security to account for all of our inventory storage areas. We are testing purchase orders and our principal office is to ensure that all received items are recorded as inventory.

We are also taking appropriate steps to account for all the items that GAO was unable to locate during its review. I would also like to note that after recently completing our own reconciliation of physical inventory, we hired a contractor to conduct an independent inventory.

The contractor sampled 819 physical inventory items, representing 25 separate locations, a broader universe than GAO used for its review.

Once completely verified by the contractors and ourselves, we had accounted for 99 percent or all but five of the items.

We agree on an improper payment side of the equation with GAO that the Pell Grant and loan disbursements made to students aged 70 years old and over may indicate potential ineligible disbursements, when there is a higher than normal concentration of such disbursements.

We have installed several improvements to strengthen the integrity of these payments. For example, we began a data matching process with the Social Security Administration's death records and implemented our new recipient financial management system to increase our grant payment controls.

Beginning in fiscal year 2002 and 2003, we will implement an edit to identify all applicants that are 75 years and older.

In just December, a few months ago, we implemented a new process to identify and review schools with abnormal concentrations of students with unique characteristics, such as age.

On the purchase card issue, I also noted in my July testimony that we had taken several important steps including significantly reducing spending limits and cutting up dozens of cards to address insufficient internal controls on our purchase card program.

Since then, we have enacted important improvement measures. These include our new electronic reconciliation and payment approval process and our recently updated directive that strengthens policies and procedures by detailing cardholder and approving official responsibilities.

We have undertaken some very significant steps involving training, administering the span of control, and developing sample methodologies and control systems to rectify this problem.

We, very frankly, must hold employees accountable for good government and for their credit card misuse, and managers for enforcing our controls, and we recently conducted an internal review of employee purchase card usage and we are going to review the actions of employees and managers who do not follow appropriate policies and procedures.

Finally, on the student financial assistance programs, which Mr. Roemer mentioned, as well, removing the student financial aid programs from off of GAO's list by fiscal year 2003 is a top management priority of the secretary's.

Consequently, Secretary Paige met with the Comptroller General and we discussed the major actions we need to complete and accomplish this goal.

GAO has outlined very specifically for us what we need to do. It includes strengthening financial management, internal controls, implementing integrated information systems to efficiently manage and control our programs, while administering high quality services, and maintaining a balanced management approach that seeks to minimize default rates and non-compliance, while promoting widespread program use.

Our new strategic plan also outlines our systems integration milestones in the student aid office. The issues regarding improving customer service while maintaining accountability, demonstrating a balanced school monitoring approach, providing a systematic income data match with the IRS to improve student eligibility, partnering with guaranty agencies, lenders and schools to improve default prevention, and improving default collections.

I would like to close by saying that the management improvements I have discussed today will enable us to move toward our goal of becoming a model agency and have performance, management, and program excellence.

Secretary Paige does want to do a good job. He wants to be the best in the entire government, and that is the goal that we are working towards.

Mr. Chairman, that is my testimony, and I'd be open to answer any questions you may have.

STATEMENT OF WILLIAM D. HANSEN, DEPUTY SECRETARY, U.S. DEPARTMENT OF EDUCATION, WASHINGTON, D.C. – SEE APPENDIX C

Chairman Hoekstra. Thank you. Without objection, I would like to submit your entire written testimony for the record. Without objection, so ordered.

There are a number of things that you didn't go into in detail in your oral testimony. You went over the part where, and maybe Ms. Lewis will get into these, you talked about the fraud cases that were out there, with the indictments and the convictions that you have received.

So if that does not come up, we will cover that in the questioning, but I think significant progress has been made in those areas, as well.

Linda?

STATEMENT OF LINDA CALBOM, DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.

Ms. Calbom. Mr. Chairman and members of the subcommittee, I am pleased to be here today to discuss the final results of our review of the Department of Education's disbursement processes.

My testimony summarizes our report that is being released today, and this report discusses the internal control problems we found at the Department of Education, the resultant improper payments, and we have made some recommendations for strengthening the department's internal controls over disbursements.

As you well know, the department has a history of financial management problems. It includes some very serious internal control weaknesses. The Inspector General and we have reported on this over the last several years.

Given this history, you asked that we assess the adequacy of internal controls over their disbursement processes. We looked at these processes between May 1998 and September 2000.

We focused on three areas, the grant and loan area, third-party drafts, and then, of course, government purchase cards, and then we also took a look at the physical controls over the computer equipment that was purchased with the third-party drafts, as well as the purchase cards.

I want to just briefly touch on our findings in each of those three areas, and, of course, Deputy Secretary Hansen has talked about a lot of the actions that the department has taken to address some of the issues that we found.

In the grant and loan area, we found that education lacked a key edit check and a follow-up process that would help identify the schools that were disbursing Pell Grants to ineligible students.

In our investigation, we found three schools that fraudulently disbursed about $2 million in Pell Grants and another school that improperly disbursed about $1.4 million. There were 31 other schools we identified that had similar types of characteristics. These disbursed about $1.6 million, and, therefore, they warrant further investigation.

We were unable to determine the validity of other potentially fraudulent or otherwise improper grant and loan payments that totaled $12 million, because the Department of Education did not provide adequate supporting documentation.

We recognize these amounts are relatively small when you compare them to the total grants that get disbursed on an annual basis, but they do represent an identified risk that could be easily exploited. So we feel that it is important to follow up in this area, and I am happy to hear some of the things that you are doing of late in response.

Our analysis of Education's third-party draft payment process disclosed significant internal control weaknesses that increase the department's vulnerability to improper payments. When we tested the third-party payment process, we found that Education employees circumvented a key computer system application control that was designed to prevent duplicate payments.

And although segregation of duties is one of the most fundamental internal control concepts, we identified some individuals at the department who could control the entire payment process for third-party drafts.

And I'm sure as you recall, in a response to a letter from the subcommittee following the April 3 hearing last year, the department took action to eliminate the use of these third-party drafts.

In our review of purchase cards, we found that the department’s inconsistent and inadequate authorization and review processes, combined with a lack of monitoring, to create an environment where improper purchases could be made with little risk of detection.

Inadequate controls in this area resulted in fraudulent, improper, and questionable purchases, totaling about $686,000.

For example, one employee made improper charges totaling $11,700 for herself and a co-worker to attend college classes that were unrelated to their jobs at the department.

In another example, we identified almost $287,000 in questionable purchases for new furniture and renovation costs related to office space that was soon to be vacated.

Further, the department could not provide any support for $152,000 of additional purchases and did not know what was acquired with these funds.

The department also lacked adequate internal controls over computers acquired with purchase cards and third-party drafts, which contributed to the loss of a 179 pieces of computer equipment, valued at almost $212,000.

Again, we found there was little or no segregation of duties in the office where most of the missing equipment was purchased.

In addition, the department had not taken a comprehensive physical inventory of equipment for at least two years and had not recorded almost $400,000 of computer purchases in its property records.

These weaknesses created an environment in which computer equipment could be easily lost or stolen without detection. The IG is investigating the disappearance of this equipment and as Mr. Hansen indicated, again, I know there are some additional procedures that have been put in place to enhance the physical controls over this equipment.

Mr. Chairman, I do want to give credit to the department for making a number of significant changes to their policies and procedures in response to our findings and earlier recommendations that we made to you, and, also, I know the letter that we provided regarding the high risk list.

There's obviously a move affront to change the culture at the department and this starts with the tone at the top, and we are encouraged by what we see there.

While these changes are very positive, there are still some cases where the new policies and procedures have not been effectively implemented and, therefore, there is some vulnerability that remain.

The report we are issuing today makes recommendations that will help the department further improve its controls to reduce its susceptibility to future improper payments.

That concludes my statement, Mr. Chairman.

STATEMENT OF LINDA CALBOM, DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.–SEE APPENDIX D

Chairman Hoekstra. Thank you. Lorraine?

STATEMENT OF LORRAINE LEWIS, INSPECTOR GENERAL, U.S. DEPARTMENT OF EDUCATION, WASHINGTON, D.C.

Ms. Lewis. Mr. Chairman and members of the subcommittee, thank you for the opportunity to discuss the Office of Inspector General perspective on financial management at the Department of Education. I will also update you on our internal controls work and some of our investigations.

While much work remains to be done, the department has made progress in financial management. Examples of these improvements were noted in Ernst & Young's report on internal

controls for the 2001 financial statement audit.

Secretary Paige's Blueprint for Management Excellence, in particular, represents a very sound plan for action.

The report on internal controls contained one material weakness and three reportable conditions. In 2000, there were three material weaknesses and two reportable conditions.

The department received a qualified opinion on all five of its financial statements this year, as it did in 2000.

The department faces significant new challenges for next year's financial statement audit. The audit will be due by February 1, one month earlier than in the past.

OMB will also require interim financial statements. In addition, the department will be using a new system, Oracle Federal Financials, to prepare its 2002 financial statements. Our audits of the implementation of Oracle did find some problems in testing, training, security, and certain aspects of the development.

The department did not agree with all of our findings, but it has planned steps to address shortcomings in the system.

We are particularly pleased that the department engaged an independent verification and validation contractor contract, which is working side by side with the department now, to identify any problems and recommend fixes.

Also, it is important for the department to focus on its interface between the department's Oracle system and the systems that contain the critical financial statement from the Office of Federal Student Aid.

We continue to examine the department's internal controls, a key factor in improving financial management. The department needs to continue to establish and maintain strong internal controls to safeguard its assets and to protect its programs and operations from waste, fraud, and abuse.

GAO has performed valuable oversight work of the department's programs and operations and has provided findings and recommendations, when implemented, should assist the department's management improvement efforts.

The secretary has made a system of strong internal controls a top priority. He convened a department-wide group to promote a culture of accountability and established an executive management team to lead this effort. He has also continued in place the management improvement team he established last year.

He has required all staff to complete on-line internal controls training by the end of this month, and the Office of Inspector General has provided guidance to the department as it planned

and prepared to provide internal controls training for its managers and supervisors, and that training has already begun.

We are supporting this top-level effort to improve management by identifying any inadequate internal controls that we have found based on our work in the department's operations and programs.

We have appreciated the receptivity of the secretary, the deputy secretary, the executive management team, and the management improvement team to our work. For example, we just recently issued an audit of the department's travel card program and this audit took place while the department itself was reviewing the travel card program, and many of the findings we made were consistent with the findings the department made based on its own review.

In that audit, we found that employees using the travel card issued to them individually made inappropriate purchases with this type of card. The billing for the card is made to the individual who was responsible for paying back Bank of America.

It is not the department's responsibility to pay this bill for these individually issued cards. We found cardholders had also made excessive withdrawals from the ATM machines.

For the individual transactions we reviewed, as I said, the department did not pay for the inappropriate purchases or for the excessive ATM withdrawals. However, there were internal control deficiencies we found in the travel card program, and the department has agreed with all of our recommendations to improve internal controls and is planning corrective actions.

We also recently completed an audit of the purchase card program and we found some areas needing attention. We recommended that the department reassess the number of cardholders assigned to an approving official and conduct on-site reviews at locations where the purchase card activity and approval are performed.

The department, again, agreed with our recommendations and is planning corrective action.

Our next audit will include transaction testing in principal offices to test adherence to the department's new purchase card directive.

We have also developed a guide to assist other Inspectors General across the government in reviewing purchase card use at their agencies.

Our investigations further assist the management improvement effort. These investigations have led to arrests, guilty pleas, a conviction, and return of government funds to the department. Since 1999, we have been conducting an investigation of a major fraud scheme involving a total of 19 people. Eight of these individuals worked for the department.

One employee, who oversaw a telecommunications contract, ordered computers, televisions, other items for herself, family members, and friends. The scheme, as our statement notes, led to more than $300,000 in property fraud and more than $700,000 in false overtime to the

department.

Fifteen defendants have pled guilty in this case, including seven department employees. One person went to trial and was found guilty on three charges. The remaining three defendants are scheduled to go on trial later this year.

Our investigation of the diversion of impact aid funds led to approximately $1.7 million being returned to the department. Since we last testified, two individuals in this case have been arrested and we are working with the FBI to locate and arrest the third person. Three persons were indicted in January.

This next matter is a new matter that we recently briefed you on, Mr. Chairman. Our investigation of the Puerto Rico Department of Education led to indictments and arrests of 17 people, including the former Secretary of Education for Puerto Rico.

None of those indicted are U.S. Department of Education employees. The former secretary and associate secretary of education from Puerto Rico have pled guilty already in this case.

Our work has led to 2.9 million in cash and property being returned to the U.S. Government.

We look forward to continuing our work with Congress and the secretary and the deputy secretary to ensure that the department's programs and operations serve the nation's students and taxpayers with efficiency, effectiveness, and integrity, and I would be happy to answer any questions.

STATEMENT OF LORRAINE LEWIS, INSPECTOR GENERAL, U.S. DEPARTMENT OF EDUCATION, WASHINGTON, D.C. –SEE APPENDIX E

Chairman Hoekstra. Thank you very much. I appreciate that update, as well as the update that we received today about the additional investigations that you can't talk about in public, and we will obviously respect that confidentiality.

The cooperation and the effective working relationship it appears that you have developed with Justice to get those kinds of not only indictments, but also the convictions. So congratulations on that.

I'm trying to think of when we did the first hearings on this. We've done six in the last two years, but we've had them before that, and I think that each time Mr. Roemer and I have started off at just about the same position, saying we hope we're just about to the end of these hearings.

I think, Linda, in your testimony, you talk about, on page seven, the second complete paragraph down, further, in July 2001, while we found evidence in the department's system that all 87 statistically sampled monthly statements had been reviewed by the cardholders' approving official, 20 of the statements had inadequate or no support for items purchased, totaling $23,151.

Based on our work, we estimate the most likely amount of unsupported or inadequately supported purchases during these three months is $65,000.

The effectiveness of the department's new approval process has been minimized because approving officials are not ensuring that adequate supporting documentation exists for all purchases.

How comfortable are we or how comfortable are the three of you that we are reaching the end of this process that we are really getting to the heart of the issues?

Because I think maybe before Mr. Holt joined the subcommittee, Mr. Roemer and I had heard the rosy scenario a number of times and if I read this, it's kind of like, oh, man, you know, we don't quite have it yet in this area, and if we don't quite have it, we're just setting ourselves up for some more work by Ms. Lewis, which is we'd actually kind of like to put her out of work or lessen her workload.

Who wants to start?

Ms. Calbom. I'll go ahead and start. I guess we feel that the department just has to do that last little push. The things that are in place, I think, are good. It's just a matter of making sure that that final follow-through occurs.

In this situation, we were glad to see that at least all the statements were approved, which is much, much better than what we found before, and what they have now is a line-by-line approval. Each transaction has to be approved.

But the problem is we received, in about 20 percent of the statements we looked at, there was documentation missing. So that the person approving it, while they could see which vendor the purchase was made from and what the dollar amount was, they wouldn't necessarily know what was actually purchased.

So that's, again, much improvement, but that is really a key step in this whole process, because as you know, with these purchase cards, that approval before payment is really the last and final and almost kind of the only control. So it really needs to be airtight.

Chairman Hoekstra. Bill?

Mr. Hansen. Mr. Chairman, I would like to add that I think while we absolutely have the process and the controls in place, as I said in my testimony, it's going to be execution and making sure that the managers are reviewing each transaction appropriately, of course, follow-up.

I do believe that the system that we put into place is going to get us to the point where we will be very, very secure about the integrity of the program.

We physically have to train people. We have to get this push down into each of the managers and employees, anybody that holds a card, into their performance agreements. So that

they understand if there is any misuse, it can have a dramatic impact upon their performance evaluation, which could have an impact on their financial rewards or other things.

So it's going to be the execution. I think we've got the tools and the processes in place. I am very pleased with the implementation to date, but we still have got to drive it down further and make it effective across the board.

I failed to do this in my opening statement, but we do have two individuals with me today that I have mentioned in passing to the subcommittee before, but two of the key members of our senior team who, hopefully, if you ever have any more hearings, they might have the benefit of being here.

Bill Leidinger is our new Assistant Secretary for Management, and Jack Martin, a Michigan native, who is our new Chief Financial Officer. These two gentlemen bring collectively about 80 years, not to date their ages or anything.

Chairman Hoekstra. They started young.

Mr. Hansen. They bring private sector experience in dealing with very complex organizations and also a lot of contracting work to the department, and we just are very pleased.

When we talk about forcing this down into the department, these gentlemen are going to be responsible for making that happen, and they are both relatively new and have already had a huge impact on making it happen.

Chairman Hoekstra. This is really kind of like your last opportunity to throw up your hands and say we walked into such a mess, we can't get it done, and we couldn't get it done in a year and a half.

Just take a look at the information that Lorraine has provided. You've have the telecommunications fraud, you've have the impact aid fraud, you've have the purchase card fraud, you've have the problem with the fraud in Puerto Rico, and each of those cases or at least, I guess, in three of those cases, we've had people, a number of people pleading guilty, all of which of those things are symptoms of the underlying problems that the department has to correct.

I don't know. Maybe Jack or Bill wants to say. I won't ask you.

Mr. Hansen. You are absolutely right. Most of these issues that we are talking about, with the indictments and the court issues, all occurred previously with different systems, different control mechanisms in place, and Secretary Paige will also be the first one to acknowledge that we own this now and we are going to take responsibility for it, and that's also the reason we, frankly, are about fixing it and making sure we don't have these problems going forward.

I will say, on some of these instances, like Puerto Rico, we can, I think, probably put just about every internal control system into place that there is, but evil people are going to do evil

things occasionally, and the important thing is to catch them when we can.

But there are a couple of these instances that I don't think any control system would have prevented that type of activity from occurring.

Chairman Hoekstra. And I think we recognize that there is a distinct difference between evil people doing evil things versus creating an environment where you foster or create the opportunity for people to take advantage of a system.

Lorraine, did you want to add anything?

Ms. Lewis. One of the excellent parts of the new program is that there will be on-site monitoring. The CFO office will be going to the principal offices and doing monitoring on-site of purchase card transactions and as GAO's work has clearly indicated, whenever you have a monitor coming on-site to test your transactions, that gets people's attention.

So that is a very key aspect of the part of the new directive that has come out of the department, and I think that sends a very powerful signal to all the principal offices, all the cardholders, and all the approving officials.

Chairman Hoekstra. The GAO also identified, either in this or a previous study, that the purchase cards were used inappropriately to buy significant amounts of computer equipment.

Ms. Calbom. Yes. What we found there, we decided that we would start at the vendor and we got serial numbers from the major vendor that the department uses, and then we went and we tried to see if we could find those pieces of computer in the department's property records.

Chairman Hoekstra. These were purchases that were made by the purchase cards.

Ms. Calbom. Right.

Chairman Hoekstra. Which were not supposed to be allowed to buy computer equipment. Right?

Ms. Calbom. Exactly. See, we weren't even supposed to be using them in the first place; that is correct. Right.

Chairman Hoekstra. Yes. And then there is the other question as to how much of that stuff is still on-site, correct? Or how much you actually could find within the department.

Ms. Calbom. Yes. There are about, I think, a 179 pieces of equipment that we still weren't able to find. From what we initially couldn't find, we found quite a bit of it.

Then when the department made their move, they had the contractor inventory the equipment and they found some additional computers, but net-net, it ended up about a 179 pieces of equipment that we still were unable to find that the department had actually paid for.

Chairman Hoekstra. I've had one last question. If you take a look at it, you know who purchased the stuff with a purchase card, right? Under the old process, if they made an inappropriate purchase of computer or electronic equipment, that is documented that this person made that purchase, which was against the regulations within the department.

Did your study take a look at what happened to the people who made the inappropriate purchase? Was there a reprimand put into their file? Then, Bill, you could maybe answer, what will happen to an employee who uses a card inappropriately in the future under the controls that you have put it.

We'll begin with you, Linda.

Ms. Calbom. Those purchases actually are, I understand, under investigation right now. But in some other cases, we did see some reprimands occur in some cases. In some cases, we didn't.

For instance, with the split purchases that we talk about, where people go over the 2,500-dollar micro purchase limit, circumventing some of the competitive bidding requirements and whatnot, in some cases, we found letters sent to the employees saying you shouldn't do this. In other cases, we didn't.

So it was kind of inconsistent, and that is one of the key things that we feel needs to be done, is that people do need to be held accountable. It sounds like the department is planning to put some of those accountability type things in place.

Mr. Hansen. That is exactly right. The important way to put this into place is to drive it into our performance agreements with each of our managers, as well as the employees. In particular, the training that each of these individuals receives, they are made very much aware of the repercussions that they will potentially face.

It obviously will depend on what the violation is, if it's a minor misstep or if it's really trying to bypass the system. But the secretary just has an absolute zero tolerance for wrongdoing and when people understand clearly what the standards are and what the thresholds are and it's in their agreement and if they make a misstep.

We now are down to a very limited number of people that have purchase card capability, and this will be a critical element, and every one of these individuals' plans, as well as their supervisors, so they will all be held accountable through the performance evaluation, but also through direct reprimand or whatever action is appropriate for any instance that might occur.

Chairman Hoekstra. Thank you. We appreciate the progress; appreciate the decisions and the actions that you took on eliminating third-party drafts and those types of things.

With that, I will yield to my colleague, Mr. Holt.

Mr. Holt. Thank you, Mr. Chairman. I thank the witnesses for good testimony, but more important, thank you for your efforts to make sure that the hard-earned taxpayer dollars from

Michigan and from New Jersey are not wasted.

It is encouraging to hear, to the extent that you have put these things in perspective, the scale of what you are talking about. Any dollar wasted, any hundreds of thousands of dollars wasted are painful to people who have paid taxes that they have worked hard to earn that money.

But it is important, I think, to make sure that we keep this in the scale that there are tens of billions of dollars of grants and loans and third-party drafts and so forth each year there.

And when the chairman says we may almost be at an end or previously we've said we may almost be at an end, I don't doubt that, in a department of that scale, we will continue to find problems, and if we want to be diligent in oversight here, this will not be at an end.

There will be ongoing oversight for decades to come, as long as we have programs of the scale that we have and as long as there are some miscreants out there.

But I do want to make sure that this doesn't turn into partisan point making. It is easy to, and well we shouldn't be too quick to condemn our predecessors, and I'm not saying that you have been, or to pin medals on ourselves for accomplishment, and I'm not saying that you've done that, either. But I just want to make sure that we don't, in the process, cast aspersions on the hardworking, conscientious people in the Department of Education who were there in the 1980s and 1990s and are there now in the 00s, no do I want us to cast aspersions on the programs of the Department of Education.

What we are trying to do is make sure that they are run efficiently and that there is a culture of accountability for every dollar that department spends.

Now, as I look at the auditor's report, which has not been discussed much here today, I find that the qualified, so-called qualified opinion that the department received on the financial statements, well, was about the same as what was received a couple of years ago.

So that it doesn't look like it is noticeably better in the period that I think the chairman was criticizing. So we want to make sure that there is progress made.

As I look at the report, there are several specific questions. On page ten, Ernst & Young notices a discrepancy of $300 million in how much the government is owed on guarantying student loans.

They say, ``We also noted differences between the amount of the FFEL loans receivable reported in the general ledger and the amounts reported by guaranty agencies. While much of the difference may be appropriately accounted for in the allowance for a loss, a new unexplained difference of approximately $300 million remained."

What accounts for the missing $300 million and why, and this would be for you, Secretary Hansen, why could the department not explain this difference to the satisfaction of the auditors?

Mr. Hansen. Let me just also answer your first observation about history. One of the first things Secretary Paige did when we came in, in fact, it was almost exactly a year ago this week, was institute this management improvement team, and this management improvement team was a network of about 12 of the top career individuals in the Department of Education.

We had nobody confirmed by the Senate this time last year, with the exception of the secretary, and he very much did want to go in and find the best and the brightest managers in the department and bring them together full-time to get our arms around the issues.

So we very much appreciate your comments about the quality team at the department, and I think that is, frankly, the challenge of any administration.

One of my previous secretary bosses called us Christmas help, we're here for a season and we're gone, and it is important for the career managers to make sure that they are part of the process and developing the solutions to the problems.

On the audits, the guaranty agency issue, we are very much working. A lot of this is a systems problem in terms of the way the data comes in from the guaranty agencies and how it's reported and how it's accounted for.

I think it is very much agreed to that there are missing dollars here. It is an accounting function and trying to align the reports up and how things were accounted for, and that is what we are working on to get that corrected.

We have similarly had about a five billion dollar problem in the direct loan program of prior year estimates that were over-estimated by about a billion dollars a year in each of the five previous years, and had to work to come to an agreement with the auditors that that was not actual dollars.

It was an estimation issue that we had to work through, and that's the types of issues that we are working through with the auditors.

Mr. Holt. Mr. Chairman, I do have another question. Should I proceed with that now?

Chairman Hoekstra. As long as it doesn't take too long.

Mr. Holt. I think the answer, the setup for the question will take a minute or so, but the answer, I think, will be brief.

Deputy Secretary Hansen, back in 1998, Congress established a new type of government entity to improve student aid management, this so-called Performance Based Organization, the PBO.

The idea was to provide greater flexibility and independence in exchange for greater accountability. The head of the PBO reports directly to the secretary and Congress explicitly gave the PBO independent control of its budget, personnel, procurement, and administrative functions.

Now, under your administration, it appears that the decisions of the PBO are being second-guessed by a committee of education officials and the secretary's Management Blueprint appears to offer what might be called micro management of the PBO, prescribing, as we count here, 70 specific actions mandated that the PBO take.

So this is moving away from this increased flexibility.

I guess the question that I have is a fairly specific one that could be answered fairly quickly, I think. Are you repudiating the idea of a PBO?

Mr. Hansen. Actually, it's going to be a longer answer, absolutely not. When Congress created the PBO in 1998, it was really done so because there were some major issues that were going on at the time with some major shortcomings in the way in which the programs were being managed.

There were shutdowns of the consolidation loan program. There were major problems getting the Federal application account. There are also contracts that account for about 750 million a year that were to be integrated and to not have 12 different systems out there running, creating duplication work for campuses, more complications for parents, and efficiency for taxpayers.

There is a stovepipe for Perkins loans, a stovepipe for Pell Grants, a stovepipe for National Student Loan Data System, a stovepipe for direct loans, et cetera, and there was never one place where you could go and find out which students have, if you put a social security number in, what type of a loan or what type of a grant.

So that was the genesis for the PBO. Congress did two things when they created the PBO. They gave the department broad authority to implement it. There was not a lot of mandate on how to implement it. There was broad authority.

They gave it some independence in its contracting and hiring authority, but they did not create an independent operation outside of the scope of the Department of Education.

The secretary of education was still accountable for the day-to-day activities, all the program operations, all the Pell Grant issues we've been talking about today, the default issues we've been talking about today.

The secretary of education is responsible and accountable for those activities. So this notion that the PBO is somehow an island off on itself, not to be governed or under the management of the Department of Education, is not what the statute intended.

It is very clear about statutory intent and the way in which it is implemented was done by memorandum of understanding. It is an internal administrative decision on which authorities to put over or under the umbrella of the PBO.

The previous administration made a decision, through five memorandums of understanding, to give quite a bit of authority over to the PBO.

This is a major piece of the operation of the Department of Education. I will just pull out one example, and that's the financial management activities.

I don't think it's an efficient operation to necessarily have two different financial management systems in the department when we are trying to get a clean audit. Frankly, we walked into the office last year, both the CFO for the rest of the department, a separate CFO over at SFA, was creating their own Oracle financial management systems.

They weren't talking to each other. This is not acceptable and this is, if anything, I think you can talk to anybody in the department about how the coordination and cooperation is now occurring and we are making much, much progress because we have people communicating in the department now about the management improvement activities of the department, about the issues that we are responsible for.

Mr. Holt. Thank you. Thank you, Mr. Chairman.

Chairman Hoekstra. Thank you. We didn't talk much about the audit for 2001. From my perspective, it is one of the things I have given Bill the opportunity to do a number of times and he refuses to take advantage of the opportunity.

But the audit for 2001, from my perspective, is really still the last statement of the financial performance of the last Administration.

These individuals that are going to help Bill have just recently or relatively recently been approved by the Senate, put on, brought in 2000. The audit for 2001 represents a good portion of the work that was done before the new Administration ever came into office.

If any of the auditors will tell you anything, to get a clean audit, and this is why I still worry about getting one for 2002, is garbage in, garbage out; that if you begin the year with poor data, it is very difficult for an auditor, at the end of that year, to give you a clean audit, because they just don't know what you started with.

I hope that we've have good information and that you're going to be able to address those, but I think getting to a clean audit for 2002 is going to be a significant hurdle, and I'm glad this team has taken that on as an objective.

But I think it's a tough hurdle to take, because I think they inherited a mess. The audit reports speak for themselves.

Mr. Schaffer.

Mr. Schaffer. Thank you, Mr. Chairman. I have a number of questions. First, dealing with the 12 million that GAO could not determine in terms of the validity of grant loans, of loans and loan payments and grants.

Ms. Calbom, can you give us some examples of these payments?

Ms. Calbom. Yes. When we did our data mining and computer matching, we came up with a population of potential improper payments. We gave those to the department and we asked them to research those for us, get some documentation, and we did clear quite a few of the things that we gave to them.

But as you said, we did have about $12 million in items we were not able to clear. I will just give you a couple examples.

One, we've had a little over a million dollars where the social security number of the individual was in the Social Security Administration's death records. The department now has a death match that they do, but at that time, they didn't, at the time of our review. So that is one instance that hasn't been cleared up yet.

Also, we had a little over $2 million in Pell Grant payments to individuals that are based, again, on their birth dates in their applications indicated that they were younger than 12 years old, and, obviously, we thought that was unusual.

Now, that being there is an error in the application or something, but, again, it's something that needs to be followed up on.

We also have about three and a half million in Pell Grants to people that are 70 years old or older. Again, there are some new matches to look at those. Of course, that's not to say that can't happen, but there were a substantial number that you wouldn't expect.

And just one last example, we found about $1.6 million in loan payments to borrowers whose Social Security numbers were not in SSA's records at all.

So those are the kinds of things we would like to see the department go ahead and continue to follow up on, just so we can see where we stand on those things and we know where are risks are as we implement our controls going forward.

Mr. Schaffer. So what happens when you find these cases? Do you trace these individual recipients; try to find out what went wrong, what happened?

Ms. Calbom. What has to be done is you've got to go and go back and figure out, for instance, go back to the application, figure out, okay, was there really just an error in this or is this really somebody who is a child genius that's 12 years old that's going to college.

In some cases, you've got to go to the school to try to get documentation. I know the department sent quite a number of requests to schools and didn't get any information back, which, to me, is problematic in and of it's self. If we're giving these schools grants, then it seems to me they ought to be receptive to inquiry.

Mr. Schaffer. Your report suggests that there are remaining concerns about an effective system to trigger this unusual data. Can you elaborate on that?

Ms. Calbom. Yes. The department's new system they are going to put in is going to be helpful in identifying patterns of unusual payments, such as the kinds of things that we looked at.

I know the department is interested in our procedures. We have already been sharing some information on that.

The issue comes down to how much of this do you follow up on, because it's labor intensive to follow up on it. We found, in the cases of discovered fraud, our Office of Special Investigations actually went and interviewed the students on the campus, and that is how you determine, in that case anyway, that is how we determined there was fraud, because there was actually some falsification of records by the schools in the students' files, which made it look as if they were eligible for the Pell Grants.

So the difficulty is it is time consuming to follow up on these things, and, again, we didn't find that much of this type of fraud, considering how many dollars go through the system.

But one thing that was disturbing is two of the three schools we had investigated back in 1993 and it was the same type of a scheme going on, and, again, just the issue is once somebody is able to do it, then others may follow.

So that is the concern.

Mr. Schaffer. Can you talk about the missing computer equipment, as well, 241 missing personal computers and computer-related equipment, about $261,000? It says 179 pieces of equipment remain missing.

Let's assume a certain amount of that is just outright stolen, but I guess I am more interested in probably the majority of it, which is just misplaced or gone.

Can you tell me about those pieces of equipment that are just missing?

Ms. Calbom. We actually did an unannounced inventory to go try to find this equipment and my folks, who are with me, behind me here, covered pretty much every square inch of the department.

They were, I guess, not escorted, but they had department people with them, and they really did a head-to-toe search.

The equipment just doesn't seem to be there. Now, some of it, originally, I think we found, initially, it looked there were 384 pieces of equipment that weren't in the inventory system. So we went out and we tried to find those.

We did find about 143 pieces of those. So we found a bunch of equipment that wasn't in the department's system that should have been and it was there, physically there.

There were still, at that time, 241 pieces of equipment we couldn't find. The department then contacted us later and said we found some more of this equipment.

They had located, they said, 86 pieces of equipment when they made their move and they had a contractor do an inventory. They said would you come back in and look at it.

We came back in, but at that time that we came back in, we were only able to find 62 pieces.

So there is still something going on there. There was an explanation given, perhaps things were surplus, but there were no records of that. So there is still some tightening up that needs to be done on that.

The other concern that we found when we went back a couple times to look at the computer equipment is we found brand new equipment still in the boxes that were in unlocked storage rooms that were accessible. So there's still a physical control issue there that needs to be addressed.

Chairman Hoekstra. I don't think Mr. Tiberi has any questions.

Mr. Tiberi. No, Mr. Chairman.

Chairman Hoekstra. Thank you. I'd like to thank you for being here today. There probably will be a seventh hearing in the series, but it may not be until there is some kind of intervening event, whether Ms. Lewis discovers or the department discovers something else or whether we just come and have a review of the audit for 2002.

That might be an appropriate time for an update, to give you a good ten, eleven months to get the team in place and see where you can take it in eleven months and hopefully build on the good work that I think all three of the groups here today are representing that they have done.

Just on behalf of this subcommittee, and I'm sure that I speak for Mr. Roemer, as well, your willingness to work with us, and I think we can genuinely get to a point where we are on the verge of getting a department that we feel good about in terms of the fundamentals.

It's not that we have said that there have been a disproportionate amount of fraud or waste or theft within the department, but we want the department to be able to do the basics, and the basics, one of the basics is providing a clean audit.

Most Fortune 500 companies do that on a regular basis. Most Fortune 1000 and other companies do that on a very regular basis. There is no reason why that is a high hurdle for a Federal agency to meet it.

I would hope that that would be the minimal standard that a Federal agency would meet, and then we can go on beyond that and talk about the actual performance and the impact that the agency is having with the dollars that they are spending.

But I think all three of the groups and the organizations that you represent have done a lot of good work in helping the department get there and have also helped the subcommittee to navigate through this process, I think, in a bipartisan and a constructive process.

So with that, I thank you very much. The subcommittee will be adjourned. Thank you.

[Whereupon, at 3:27 p.m., the subcommittee was adjourned.]

APPENDIX A -- OPENING STATEMENT OF CHAIRMAN PETER HOEKSTRA, SUBCOMMITTEE ON SELECT EDUCATION, COMMITTEE ON EDUCATION AND THE WORKFORCE, U.S. HOUSE OF REPRESENTATIVES, WASHINGTON, D.C.

Hearing of the Subcommittee on Select Education
Committee on Education and the Workforce
House of Representatives
"Status of Financial Management at the Department of Education"
Opening Statement of Chairman Pete Hoekstra (R-MI)
April 10, 2002

Good afternoon. Thank you for coming here to discuss the status of financial management at the Department of Education. This is the sixth in a series of hearings we have held that examine the Department's financial management practices.

However, this is the first time we will actually hear about the significant, measurable progress that has been made to correct the problems at the Department – thanks in large measure to Secretary Paige's leadership and the efforts of today's panelists. Of course, I think we all recognize that we still have a long way to go.

As everyone will recall, for the last three years of the Clinton Administration, the Department failed three consecutive annual audits of its financial statements. During our hearing last April, we heard that an estimated $450 million was lost to waste, fraud, and abuse. In July of

2001, we heard from the General Accounting Office and Department's Inspector General about inadequate internal controls that may have lead to improper payments.

Today, we will learn about Secretary Paige and the Administration's efforts to clean up what simply can be called an inherited mess. We will also learn about the results of the GAO fraud audit of the Department, which was requested by this committee. Specifically, the GAO was asked to examine the internal controls for the Department's disbursement processes and search the Department's records for possible instances of improper payments.

As I mentioned before, the good news is that progress has been made. Secretary Paige's new Management Improvement Team has implemented all but one of its 661 recommendations for management improvement based on recommendations from the General Accounting Office, the Student Financial Assistance Performance Plan, the Office of the Inspector General, and other internal reviewers. This represents a remarkable achievement in less than one year. The Management Improvement Team has also addressed 93 recommendations from the Office of Inspector General by either implementing or developing corrective action plans for them.

In October of last year, the Department issued a Blueprint for Management Excellence, which will guide the department's long-term actions toward improving the efficiency and effectiveness of the Department. Secretary Paige has created an Executive Management Team to oversee the management improvement process. I believe that this level of commitment, at the highest levels of the agency, truly will change the culture at the Department of Education.

The Department has curbed practices most ripe for abuse. The Department has eliminated the use of third-party drafts, which were checks that could be written for up to $10,000 with little monitoring. In addition, the Department has issued new directives for the use of purchase cards, significantly reduced spending limits, and retrained both card-holders and their supervisors.

The bad news is that the Department of Education has yet to fully recover from the previous Administration's lack of a commitment to financial management. For the fourth consecutive year, the Department has failed to obtain a clean audit report. Instead, the Department received a qualified opinion for FY 2001 by the auditing firm of Ernst & Young. A qualified opinion means that the statements and accompanying records lack adequate information to render an

unqualified opinion. However, even here progress has been made. The Department received only one material weakness and three reportable conditions, compared to last year's three material weaknesses and two reportable conditions. Secretary Paige is committed to obtaining a clean audit opinion.

In addition, the GAO will remind us of the importance of continued vigilance to ensure new directives are followed. New policies and procedures are only as effective as their implementation.

Further evidence of past mismanagement occurred earlier this year when multiple fraud investigations moved toward resolution. Additional guilty pleas were rendered in a case against Department employees and telecommunications contractors. This case dates back to 1999. These individuals defrauded the government of over $1 million in electronics equipment and false overtime charges. In addition, two individuals were arrested for conspiring to illegally receive and retain stolen property purchased using $1.9 million in Impact Aid funds.

We hope that these convictions and arrests only reinforce how the tide has changed for financial management at the Department of Education.

As stewards of hard-earned taxpayer dollars, I think I speak for all of us in our desire to continue to work with Secretary Paige and the new Administration to ensure that the Department's books are in order and that the proper systems are in place to prevent the waste, fraud, and abuse.

At this time, I will yield to my friend and Ranking Member, Congressman Tim Roemer for any statement he may have.

APPENDIX B -- OPENING STATEMENT OF RANKING MINORITY MEMBER TIM ROEMER, SUBCOMMITTEE ON SELECT EDUCATION, COMMITTEE ON EDUCATION AND THE WORKFORCE, U.S. HOUSE OF REPRESENTATIVES, WASHINGTON, D.C.

Congressman Tim Roemer, Ranking Member
Subcommittee on Select Education
Hearing on "Status of Financial Management at the Department of Education"
April 9, 2002 at 2pm

Mr. Chairman, like you, I am very interested in ensuring that our tax dollars are being used wisely and that the Department of Education's financial management practices are sound. This is the sixth hearing that we have had on this in the last two years, and I look forward to the day when these hearings are no longer necessary.

I want to congratulate the Department for working towards obtaining a clean audit, and I hope that next year it will become a reality. This was started by the first Bush administration. When, Richard Riley took over as Secretary, Deputy Secretary David Kearns, was in the early stages of making some needed changes. Secretary Riley made improving financial management a top priority during his time as Secretary, and I'm glad to see that Secretary Paige shares this level of commitment.

The Clinton administration was committed to working towards a clean audit and ridding the Department of Education of fraud and abuse. I am

pleased with some of the positive steps that have been taken. The cohort default rate on student loans has declined for seven consecutive years and was at a record low 6.9 percent at the beginning of this year. Collections on defaulted loans have more than doubled, from $1 billion in FY 1993 to over $3 billion in fiscal year 1999. Data improvement in the National Student Loan Data System has prevented the disbursement of as much as $1 billion in grants to ineligible students.

Mr. Hansen, I look forward to hearing about the improvements that you and Secretary Paige have made so far. I hope that soon these financial management problems will be behind you so that you are both freed up to work on important education policy such as the Individuals with Disabilities Act.

Mr. Chairman, thank you for holding this hearing and I look forward to the day when these hearings are no longer necessary.

APPENDIX C -- STATEMENT OF WILLIAM D. HANSEN, DEPUTY SECRETARY, U.S. DEPARTMENT OF EDUCATION, WASHINGTON, D.C.

Deputy Secretary Hansen's Testimony

Before the Committee on Education and the Workforce

Subcommittee on Select Education

Peter Hoekstra, Chairman

April 10, 2002

Mr. Chairman and Members of the Subcommittee:

First, let me thank you for the opportunity to discuss the Department's progress towards improving financial management and instituting an improved Culture of Accountability. I would also like to thank you and other committee members for your continued efforts to help us identify and address the Department's management problems, and guide us in the direction we need to go.

Today I would like to discuss four primary management activities we have undertaken to further management improvements at the Department. We:
(1) continued to implement outstanding audit improvement recommendations and *Blueprint for Management Excellence* action items; (2) created the Executive Management Team, which consists of top political appointees and career senior managers who are overseeing our management improvement process;
(3) entered into partnerships with the National Academy for Public Administration, the Private Sector Council, and the Council for Excellence in Government to further our commitment to management excellence in the areas of human capital planning, restructuring and strategic outsourcing; and

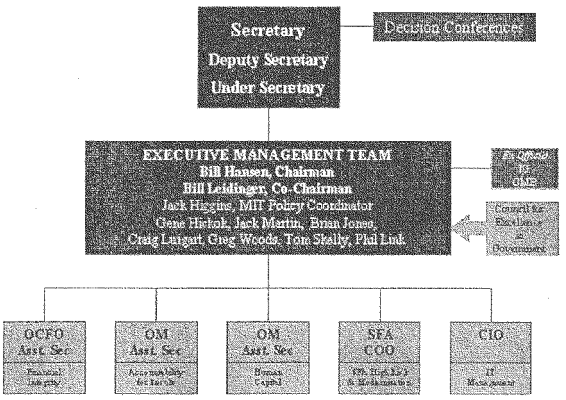
(4) established a Culture of Accountability Team to help achieve a more ingrained Culture of Accountability across the Department. I will also summarize our recent financial statement audit results and pertinent management issues.

Audit Improvement/*Blueprint* Recommendations. I last testified before you in July 2001, and since then we have continued to work toward overcoming our management problems. At that time I testified that we had taken action on slightly more than 300 of the original 661 outstanding audit improvement recommendations that the Management Improvement Team was seeking to implement. Since then we have continued to implement corrective actions for these items, and I am pleased to report that we have acted on all but one of these items, having either closed or developed corrective action plans to address them. This includes acting on all the items we deemed to have the highest priority. Moreover, we have addressed an additional 93 OIG audit recommendations as well, either implementing or developing corrective action plans for them. We plan to continue working closely with both our OIG and the GAO to ensure that we address any lingering management concerns so that we may achieve accountability and truly become a high-performance organization.

In October the Management Improvement Team released its *Blueprint*, which contained 140 action improvement recommendations targeted toward addressing longer term and structural issues that hinder the efficient and effective performance of the Department. Since that date the Management Improvement Team has added another 36 action recommendations. These additional items align with both the President's Management Agenda and the Department's Strategic Plan. The Management Improvement Team actively tracks the *Blueprint* to ensure successful implementation of these management items. Since October we have completed approximately fifteen percent of the *Blueprint* Action Plan items, and are making significant progress toward completing many others. The *Blueprint* demonstrates our commitment to excellence and establishes a roadmap to realize further improvements and create mechanisms for achieving accountability and high performance throughout the Department. And with the implementation of our Strategic Plan, we intend to make performance the basis of every program decision.

Executive Management Team. We have further strengthened and institutionalized our successful process for resolving management deficiencies by creating and operationalizing the Executive Management Team, which consists of top political appointees and career senior managers. The Executive Management Team directs and oversees Strategic Plan execution, in addition to implementing the President's Management Agenda and our *Blueprint.* I chair the Executive Management Team and Bill Leidinger, our Assistant Secretary for Management, co-chairs. The Management Improvement Team serves as core staff assisting with specific responsibilities relating to Financial Integrity, Accountability for Results, Human Capital, SFA High Risk & Modernization and IT Management.

A Structure for Implementing the Blueprint for Management Excellence



OMB agrees with our aggressive management approach and has indicated they will rate our progress towards satisfying the President's Management Agenda based largely upon our success in meeting already-established *Blueprint* milestones. OMB has informed us, and I quote, that: "ED has developed robust plans to address longstanding problems

pertaining to financial management, high-risk in student financial aid programs, and IT security."

Plans, of course, are not by themselves sufficient to ensure success. We must continually monitor their implementation, make adjustments as needed, and devote the necessary resources to ensure that we continue to make improvements and successfully address any lingering problems we have not yet overcome.

Public/Private Partnership. In keeping with the President's Management Agenda, the Department plans to publish a Five-Year Human Capital, Strategic Sourcing and Restructuring Plan in June 2002. Teams of employees are formulating plans working with the advice and assistance of the National Academy of Public Administration, the Private Sector Council, and the Council for Excellence in Government. We will tailor these plans to ensure the Department has sufficient human resources and contract support, as well as the appropriate structure to achieve the Department's Strategic Plan, *Blueprint* and Culture of Accountability goals. The Five-Year Human Capital, Strategic Sourcing and Restructuring Plan will address such issues as maximizing workforce performance, improving efficiencies and citizen access to our programs and services, and finding the right blend of Department employees and contractors to facilitate financial integrity and appropriate oversight of our programs and services. As a result, we can expect to achieve the results necessary to perform our mission with a greater degree of integrity.

Accountability Team. I testified in July that our biggest challenge was developing a Department culture that emphasized individual responsibility and accountability. We have taken significant steps in that direction. In December Secretary Paige established a team of career and political employees from across the Department who completed a set of specific actions with assigned ownership, clear timetables and performance measures that will establish a mature Culture of Accountability within our agency. The Team developed these actions based upon ideas and feedback obtained from employees across the Department, which will help promote buy-in from all our employees. The Executive

Management Team and Management Improvement Team will ensure these actions become reality.

Additionally, we are close to implementing an employee appraisal process that emphasizes accountability. Every senior officer, including myself, will sign a performance contract with Secretary Paige that will hold us accountable for results. Every manager and employee will have a performance agreement that reflects the Department's goals and objectives, and establishes clear individual job performance expectations. Moreover, this process will incorporate specific President Management Agenda, *Blueprint* and Strategic Plan items, establishing accountability for all our employees to work together to ensure that No Child is Left Behind.

Financial Statements/Related Financial Management Issues

Financial Statements. We recently received a qualified opinion on our FY2001 Financial Statement audit. The results included one material weakness and three reportable conditions. These results reflect noticeable improvement and significant progress from last year's three material weaknesses and two reportable conditions. We are making steady progress toward Secretary Paige's stated goal of obtaining a clean audit opinion by FY2002 (for the FY2002 statements).

We received the qualified opinion due to two primary reasons: we provided insufficient evidence to support the accuracy or completeness of our general ledger adjustments, and did not provide adequate documentation to support certain amounts reported in our consolidated balance sheets. These adjustments were required to compensate for continued financial system and reporting weaknesses during previous fiscal years. Although we have vastly improved our account analysis and reconciliation processes, our auditor did not feel there was sufficient documentation to support the accuracy or completeness of our corrections.

During the current fiscal year, the Department has taken major steps to remedy our last material weakness in Financial Management Systems and Financial Reporting by

implementing a new general ledger system – Oracle Federal Financials – on January 22, 2002. We expect our new accounting system to help correct many deficiencies that resulted primarily from the lack of a fully integrated financial management system. This improves our chances of getting a clean audit in FY2002 and will allow our managers to obtain timely information they can use to make more productive program decisions. We are currently reviewing our business procedures to ensure the integrity of our internal controls, reconciliation processes, and account analysis procedures to take advantage of the new system's capabilities. Once the system and accounting processes are stabilized, we can fully address any remaining problems with our older underlying data.

We have made other significant accounting improvements, including major upgrades to our Grants Administration and Payments System and Contract & Purchasing Support System. We are correcting accounting errors and our standard accounting transactions will be fully compliant with Federal Accounting Standards. We put extensive cross validation edits into place between Federal Student Aid and other Departmental systems that will greatly improve our data quality. We performed extensive analysis of our historical accounting data, and are identifying data integrity issues and developing a remedial plan to overcome them.

To further support our efforts toward obtaining a clean opinion, we have arranged to have a contractor provide a pilot internal Financial Management Certificate Program. This program is targeted toward specific Office of the Chief Financial Officer and Federal Student Aid employees. Participants will acquire additional financial management skills that will provide them with an improved understanding of federal budgeting, performance management, the U.S. Standard General Ledger, appropriations law, reconciliation, credit reform and process improvement techniques. This training program emphasizes financial standards and procedures, fiscal integrity and enhanced performance, and supports the Department's strategic direction in its efforts to improve its financial performance.

We will continue to address the reportable conditions – information technology, credit reform reporting, and property and equipment – reported in our recent Financial

Statements audit by completing applicable *Blueprint* action items. I will now discuss these items.

Information System Controls. Our GISRA Plan of Action and Milestones addresses reportable conditions in our information systems controls, including an assessment of the recently identified worldwide Internet vulnerability. In light of this vulnerability and the enormous corresponding security actions we are undertaking to combat it, I have asked senior leadership to develop a new baseline plan balancing our resources while taking the new security actions into account. We expect to complete independent risk assessments on all our systems in the third quarter to identify missing or incomplete controls. We will remediate these weaknesses prior to certification. At the same time, we are developing a management process to ensure we include appropriate controls in any future information systems we acquire. We also are devising baseline security requirements for all our systems.

Inventory. To improve our asset management policies and procedures, we are centralizing inventory responsibility within our Office of Management and documenting our detailed property management procedures. We are also incorporating contractor recommendations into our property management procedures. We expect to issue these new policies and procedures in June 2002, and will hold our employees accountable for following them.

We are addressing specific issues that GAO raised, including recording our inventory when initially purchased, and appropriately securing and accounting for any items once received. We are increasing security to account for all our inventory storage areas. We are testing purchase orders in our principal offices to ensure that all received items are recorded as inventory. We are also taking appropriate steps to account for all the items that GAO was unable to locate during its recent review.

I would like to note that after recently completing our own reconciliation of physical inventory, we hired a contractor to conduct an independent inventory. The contractor

sampled 819 physical inventory items representing 25 separate locations – a broader sample than GAO's and performed more recently. Once completely verified by the contractors and ourselves, we had accounted for 99%, or all but five of the items.

Credit Reform. Credit reform issues are extremely complex, and we have invested enormous resources in Federal Student Aid, the Office of the Chief Financial Officer, and our Budget Service to monitor credit program activity, implement systemic improvements in credit reform processes, and ensure that managers and staff from these offices are smoothly integrated in an effective and efficient overall process. These activities include improving account reconciliations and analysis and documenting final adjustments to address long-standing issues. We believe our efforts thus far have been successful, and we are committed to further improving our processes and management controls.

In summary, regarding our financial statements, I believe we will realize our goal of obtaining a clean audit opinion by next year. This is one goal we must accomplish to restore the Congress' and American people's confidence in us.

Additional Internal Control/Accountability Issues

We constantly review the way we do business, and in particular we are seeking ways to improve the internal controls that govern our procurement process. Because this area has been subject to abuse, we want to make sure we minimize the chance of reoccurrences to the greatest degree possible, and take swift actions against any employee found violating appropriate Department policies and procedures. To ensure this occurs, we are updating internal policy directives, informing employees of these changes, and putting policies into place to hold managers accountable for their implementation. To date, we have updated six directives, including our purchase card and property management directives.

We have moved as swiftly as processes will allow to take action against employees, contractors, or anyone who obtains government funds illegally or attempts to defraud the Department. Recently, nearly all the funds and property – including two luxury SUVS –

obtained with $1.9 million in illegally obtained Impact Aid grant funds were seized and forfeited to the United States while approximately $1.7 million was returned to the Department. In December, three non-employees were indicted for conspiracy, money laundering, identity fraud and other charges and two of the three have been arrested. We are working with the FBI to locate and arrest the third individual.

An ongoing investigation of 19 individuals, including eight Department employees, who purchased and/or received electronic equipment paid for with federal funds for non-business related purposes, and billed the Department for overtime hours not worked, has resulted in 15 of the defendants pleading guilty, including seven of the eight Department employees. A sixteenth defendant also has been found guilty by a jury. Two of the three remaining defendants (including the last Department employee) are scheduled to go to trial in April 2002; the third is scheduled for trial in October 2002. The property was valued at more than $300,000, including computers and other electronic equipment, while there was an estimated $700,000 in false overtime charges.

We have also obtained guilty pleas from two private-sector furniture store employees for the theft of government property. These individuals were charged with acting in concert with Department employees to use the employees' government-issued credit card to purchase residential furniture for their personal use. The charging documents state that the furniture store employees then concealed these purchases by falsely invoicing the government for office furniture purchases.

In another example, seventeen individuals were indicted in Puerto Rico, including the former Puerto Rico Secretary of Education and former Associate Secretary of Education, for extorting and obtaining kickbacks totaling approximately $4.3 million from several contractors in return for awarding approximately $138 million in contracts. The indictment charged these individuals with extorting the money for the benefit of their political party and personal enrichment, and awarding contracts to companies they owned and controlled. Additionally, a contractor who was the sister-in-law of the former Puerto Rico Secretary of Education was accused of assisting in the extortion scheme by accepting and channeling extortion payments through a company known as National

Consulting Group. National Consulting Group was a company owned by the former Secretary. All three individuals have pled guilty to various federal charges involving extortion, program fraud and money laundering. The plea agreements provide for a $2.9 million forfeiture to the government.

GAO Report. I would like to now address several internal control issues that GAO has recently highlighted.

Improper Payments. We agree with GAO's concern that Pell Grant and loan disbursements made to students aged 70 and over may indicate potential ineligible disbursements when there is a higher than normal concentration of such disbursements. The GAO's findings state four schools disbursed approximately $3.4 million in Pell Grants to ineligible students. I think it is important to emphasize that GAO reviewed FSA loan and grant disbursements totaling $78 billion at thousands of schools. The $3.4 million improperly disbursed was concentrated at four schools and represents only a small proportion of the overall disbursements GAO reviewed. While we can undoubtedly improve our systems and internal control processes, we believe our current controls are strong and provide reasonable assurance that we are meeting our objectives.

We have taken several steps to strengthen the integrity of these payments, even before GAO began its audit work. For example, we began a matching process with the Social Security Administration's death records, and we implemented our new Recipient Financial Management System, increasing controls over grant payments. In addition, we will implement an electronic edit to identify all applicants whose birth date indicates they are 75 years of age or older beginning in 2002-03. In such cases, the applicant must verify his or her birth date before we process their Free Application for Federal Student Aid (FAFSA). We will not disburse funds to an applicant until a FAFSA is completely processed by our Central Processing System and an estimated family contribution is calculated. As an interim process to address this sensitive issue, in December we analyzed National Student Loan Data system data to identify high concentrations of students older than 65, along with other criteria, to determine if student eligibility problems existed. With GAO and our OIG's assistance, we will refine our methodology

for analyzing this information and conducting reviews at institutions to address the issues GAO identified.

We continue to work toward strengthening our internal controls further. We have begun to analyze our data in a more systematic manner to establish baselines and indicators to focus our resources more effectively and, as GAO noted, will implement a new Common Origination and Disbursement system to assist us in identifying unusual activity.

Purchase Cards. At the time of my July testimony, we were in the process of addressing our lack of internal controls in the purchase card program. We had reduced the spending limits on government purchase cards – some by more than 90 percent – and required all purchase cardholders and approving officials to go through mandatory training on appropriate card usage, and were taking steps to ensure that all approving officials review their cardholders' statements each month.

Since then, we have taken numerous measures to strengthen our Purchase Card controls further. We recently updated our Directive, which strengthens our policies and practices regarding appropriate purchase card use. Since January 2001, as required we have trained all cardholders and approving officials on appropriate policies and procedures. We released the Directive to all cardholders, approving officials, executive officers, and supervisors with an on-line self-test to emphasize key policy changes.

Additionally, the revised Directive and additional procedures provide detailed instruction on cardholder and approving official responsibilities for reviewing and approving purchase card transactions. With our new electronic reconciliation and payment approval process, the cardholder electronically provides reports to the approving official to document the cardholder's transaction activity for the billing period, automatically creating a record. This is in addition to the hard copy receipts submitted for the approving official's review. Further, the Office of the Chief Financial Officer distributes monthly management reports to each principal office to review their cardholder purchase card transaction activity.

We will also conduct quarterly internal control and quality reviews of sample purchase card transactions to: a) ensure purchases above the micro-purchase threshold are made only by warranted officials; b) review purchases to determine that individual purchases are appropriate, goods and services were properly received and accepted, and that payment was proper using merchant category codes and by examining the record; c) ensure appropriate separation of duties between the cardholder and the approving official; and d) ensure that procurements are not split into more than a single purchase to circumvent rules that apply to purchases exceeding the micro-purchase threshold or to circumvent purchase card limits.

The Department has blocked more than 300 transactions using merchant category codes as recommended by the GAO. The Office of the Chief Financial Officer will utilize this data to identify potential transactions subject to purchase card restrictions, or to identify additional codes that may track to improper purchases.

Regarding GAO's finding of unauthorized payment of tuition with a purchase card, we are following established debt procedures to recover questionable costs. We will also follow up on the $218,000 in questionable purchases to determine validity and propriety. In addition, we will continue to improve our ability to readily obtain supporting documentation. Our newly published Directive highlights this effort.

We have diminished the span of control for approving officials—fewer cardholders per approving official, to ensure direct knowledge of the cardholder's purchasing activity. We have developed sampling methodologies for reviewing purchase card transactions. We have learned from GAO's approach and begun to use data mining strategies to review monthly purchase card activity.

We must hold employees accountable for misuse of government credit cards and managers accountable for enforcing the controls over them. We have recently conducted our own internal review of employee purchase card usage and are in the process of taking

action against employees and managers who did not follow appropriate policies and procedures.

Third Party Drafts. GAO has recommend that we pursue resolution for $1.7 million in third party draft payments for which we did not provide adequate supporting documentation. We abolished the use of third party drafts in May 2001. We have referred the $1.7 million in unresolved items to our Office of Inspector General for further investigation.

Travel Cards. Our internal reviews have indicated that we need to strengthen our travel card program internal controls. Since last summer we have implemented a new on-line travel card reporting tool, allowing cardholders and supervisors to get account information more quickly and easily. Cardholders and managers can examine individual accounts, transactional information, summaries and historical information on-line, monitoring accounts and reconciling statements. Managers use this information to check the status of outstanding balances and unauthorized usage. Because these on-line tools are new, the travel office is conducting training sessions for cardholders, supervisors and executive officers to demonstrate the tools available to them.

We are also conducting additional training for supervisors and Executive Officers, detailing the responsibilities supervisors have in overseeing travel activities. Managers are instructed how to monitor unauthorized charges and unpaid balances, and how to take corrective actions regarding any travel issues. Specific duties, responsibilities and actions are outlined.

As a result of the instruction and availability of new tools, we have taken more corrective actions against employees. The outstanding balance for travel cardholders has declined since October, and the number of disciplinary actions for improper travel card usage has increased. We have taken steps to pay off all outstanding balances, and to cancel or suspend accounts with outstanding balances.

We have also completed a top to bottom review of our Travel Card policy, and are now in the process of considering several recommendations for additional internal controls to strengthen the travel card program.

Internal Control Team. We have established an Internal Controls Team to help establish greater accountability for internal controls within the agency. Currently, the Team is focused on completing the first of regular reviews of internal controls that support our primary activities. They will implement recommendations and ensure that our employees understand and apply internal controls in Department operations. Team members will provide reports to management on their review findings and recommendations. The Team has also recently developed internal control training initiatives for all employees and separate training for managers. The Team Leader also chairs the Department's newly-formed Accounting Integrity Board.

Student Financial Assistance Programs

As you know, Secretary Paige has determined that removing the Student Financial Assistance programs from GAO's High Risk List by FY2003 is a top management priority. A key step to addressing this issue was his meeting with the Comptroller General who informed us about the major actions we need to complete in order for GAO to remove the Student Financial Assistance programs from the High Risk List. The issues center around:

- Strengthening financial management and internal controls;
- Implementing integrated information systems to efficiently manage and effectively control the programs while administering high quality services to customers; and
- Maintaining a balanced management approach that seeks to minimize noncompliance and default rates while still promoting widespread program use.

I believe you will find our efforts over the last year demonstrate our commitment to addressing these issues. Federal Student Aid's Performance and High Risk Plans identify key projects geared towards integrating its systems; improving customer service while

maintaining accountability; demonstrating a balanced approach to school monitoring; providing a systematic income data match with IRS to improve student eligibility; partnering with guaranty agencies, lenders and schools to improve default prevention; and improving default collections.

Federal Student Aid and other Department managers meet weekly to track related management projects to ensure their success. Through our employee appraisal process, we are assuring that successful completion of these projects is critical to the success of every Federal Student Aid manager and employee. Although GAO has accurately stated that the Student Financial Assistance programs are inherently risky because of their nature (providing loans and grants through third parties to students without credit histories), I am confident these projects, along with our initiatives to improve financial management and internal controls and our human resource initiatives, will address GAO's concerns about Student Financial Assistance program risk.

I would like to close by saying that the management improvements I have discussed today will help enable the Department to move toward its goal of becoming a model agency of management and program excellence.

That concludes my testimony, and I would be happy to answer any questions you may have.

APPENDIX D -- STATEMENT OF LINDA CALBOM, DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Select Education, Committee on Education and the Workforce, House of Representatives

For Release on Delivery
Expected at
2 p.m.
Wednesday,
April 10, 2002

EDUCATION FINANCIAL MANAGEMENT

Weak Internal Controls Led to Instances of Fraud and Other Improper Payments

Statement of Linda Calbom

Director, Financial Management and Assurance

GAO-02-513T

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the final results of our review of the Department of Education's disbursement processes and how significant internal control weaknesses led to instances of fraud and other improper payments. My testimony summarizes our report being released today,[1] which discusses the internal control problems we found at Education, the resultant improper payments, and recommendations for strengthening internal controls over disbursements.

As we discussed in our two testimonies before this subcommittee last year,[2] the Department of Education has a history of financial management problems, including serious internal control weaknesses. These weaknesses have affected Education's ability to provide reliable financial information to decisionmakers both inside and outside the agency and to maintain the financial integrity of its operations. We and Education's Office of Inspector General (OIG) have issued many reports over the last several years on the financial challenges facing the department and the need to eliminate internal control weaknesses to reduce the potential for fraud, waste, abuse, and mismanagement.[3] In addition, since 1990, we have designated Education's student financial assistance programs as a high-risk area for fraud, waste, abuse, and mismanagement.[4] Given the billions of dollars in payments made by Education each year and the risk of erroneous or fraudulent payments making their way through Education's processes without prevention or detection, you requested that we audit selected department accounts that may be particularly susceptible to improper payments.

In response to your request, we assessed internal controls over Education's processes for (1) disbursing grants and loans, (2) paying for purchases with third party drafts, and (3) use of government purchase cards, and determined whether any fraudulent or otherwise improper payments were made in these areas. Our review covered the period May 1998 through September 2000 during which time Education disbursed $181.5 billion through these processes—$181.4 billion in grants[5] and loans, $55 million in third party drafts, and $22 million

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[1]U.S. General Accounting Office, *Education Financial Management: Weak Internal Controls Led to Instances of Fraud and Other Improper Payments*, GAO-02-406 (Washington, D.C.: March 28, 2002).

[2]U.S. General Accounting Office, *Financial Management: Poor Internal Control Exposes Department of Education to Improper Payments*, GAO-01-997T (Washington, D.C.: July 24, 2001) and *Financial Management: Internal Control Weaknesses Leave Department of Education Vulnerable to Improper Payments*, GAO-01-585T (Washington, D.C.: April 3, 2001).

[3]U.S. General Accounting Office, *Financial Management: Financial Management Challenges Remain at the Department of Education*, GAO/T-AIMD-00-323 (Washington, D.C.: September 19, 2000); *Financial Management: Review of Education's Grantback Account*, GAO/AIMD-00-228 (Washington, D.C.: August 18, 2000); *Financial Management: Education's Financial Management Problems Persist*, GAO/T-AIMD-00-180 (Washington, D.C.: May 24, 2000); and *Financial Management: Education Faces Challenges in Achieving Financial Management Reform*, GAO/T-AIMD-00-106 (Washington, D.C.: March 1, 2000).

[4]U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Education*, GAO-01-245 (Washington, D.C.: January 1, 2001) and *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.: January 1, 2001).

[5]Because Education's Pell Grant data are maintained by school year, the time frames for the Pell Grant disbursements we reviewed were for school years 1997-1998, 1998-1999, and 1999-2000.

in purchase card transactions. While we identified some fraudulent and improper payments, our work was not designed to identify all fraudulent or otherwise improper payments made by the department. In addition, we assessed Education's physical controls over its computer equipment. We also assessed the effectiveness of changes to Education's process for purchase card purchases, which took effect in July 2001 following our prior testimony before this subcommittee. Our work built upon earlier work done by Education's OIG in which the OIG identified weaknesses in the department's third party draft and purchase card processes.

To summarize, we found that significant internal control weaknesses in Education's payment processes and poor physical control over its computer assets made the department vulnerable to and in some cases resulted in fraud, improper payments, and lost assets. We identified several instances of fraud in the grant and loan areas and pervasive control breakdowns and improper payments in other areas, particularly involving purchase cards. Further, because of the risks we identified in the third party draft process, Education eliminated their use. My testimony today discusses our findings in each of these areas, as well as some of the actions Education has taken to address the problems we identified.

Controls over Grants Disbursement Process Failed to Detect Certain Improper Payments

As we testified in July 2001, controls over grant and loan disbursements did not include a key edit check or follow-up process that would help identify schools that were disbursing Pell Grants to ineligible students. To identify improper payments that may have resulted from the absence of these controls, we performed tests to identify students 70 years of age and older because we did not expect large numbers of older students to be receiving Pell Grants,[6] and in 1993, we identified abuses in the Pell Grant program relating to older students.[7] Based on the initial results of our tests and because of the problems we identified in the past, we expanded our review of 7 schools that had disproportionately high numbers of older students to include recipients 50 years of age and older. We found that 3 schools fraudulently disbursed about $2 million of Pell Grants to ineligible students, and another school improperly disbursed about $1.4 million of Pell Grants to ineligible students. We also identified 31 other schools that had similar disbursement patterns to those making the payments to ineligible students. These 31 schools disbursed approximately $1.6 million of Pell Grants to potentially ineligible students. We provided information on these schools to Education for follow-up.

Education staff and officials told us that they have performed ad hoc reviews in the past to identify schools that disbursed Pell Grants to ineligible students and have recovered some improper payments as a result. However, Education did not have a formal, systematic process in place specifically designed to identify schools that may be improperly disbursing Pell Grants. In September 2001, we issued an interim report[8] in which we recommended that the Secretary of Education (1) establish appropriate edit checks to identify unusual grant and loan disbursement

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[6]A Pell Grant is a form of financial aid that is awarded to undergraduate students who have not earned bachelor's or professional degrees, and who are enrolled in degree or certificate programs.

[7]U.S. General Accounting Office, *Student Financial Aid Programs: Pell Grant Program Abuse*, GAO/T-OSI-94-8 (Washington, D.C.: October 27, 1993).

[8]U.S. General Accounting Office, *Financial Management: Poor Internal Controls Expose Department of Education to Improper Payments*, GAO-01-1151 (Washington, D.C.: September 28, 2001).

patterns and (2) design and implement a formal, routine process to investigate unusual disbursement patterns identified by the edit checks.

In our July 2001 testimony, we told you that Education decided to implement a new edit check, effective beginning with the 2002-2003 school year to identify students who are 85 years of age or older. We explained that we believed the age limit was too high and would exclude many potential ineligible students. Education subsequently lowered the age limit for that edit to 75 years of age or older. If the student's date of birth indicates that he or she is 75 years of age or older, the system edit will reject the application and the school will not be authorized to give the student federal education funds until the student either submits a corrected date of birth or verifies that it is correct. However, without also looking for unusual patterns and following up, the edit may not be very effective, other than to correct data entry errors or confirm older students applying for aid.

Education is also in the process of implementing a new system, called the Common Origination and Disbursement (COD) system, which is to become effective starting this month. Education officials told us that this integrated system will replace the separate systems Education has used for Pell Grants, direct loans, and other systems containing information on student aid, and it will integrate with applicant data in the application processing system. The focus of COD is to improve program and data integrity. If properly implemented, a byproduct of this new system should be improved controls over grant and loan disbursements. According to Education officials, they will be able to use COD to identify schools with characteristics like those we identified. However, until there is a mechanism in place to investigate schools once unusual patterns are identified, Education will continue to be vulnerable to the types of improper Pell Grant payments we identified during our review.

We identified over $32 million of other potentially improper grant and loan payments. Based on supporting documentation provided to us by Education, we determined that over $21 million of these payments were proper. However, because Education did not provide adequate supporting documentation, we were unable to determine the validity of about $12 million of these transactions or conclude on the effectiveness of the related edit checks. While the amount of improper and potentially improper grant and loan payments we identified is relatively insignificant compared to the billions of dollars disbursed for these programs annually, it represents a control risk that could easily be exploited to a greater extent.

During our investigation of potentially improper transactions, we found that two students submitted counterfeit Social Security cards and fraudulent birth certificates along with their applications for federal education aid, and they received almost $55,000 in direct loans and Pell Grants. The U.S. Attorney's Office is considering prosecuting these individuals.

During our tests to determine the effectiveness of Education's edit checks, we also found data errors, such as incorrect social security numbers (SSN) of borrowers, in the Loan Origination System (LOS), which processes all loan origination data received from schools. Such errors could negatively affect the collection of student loans because without correct identifying information, Education may not be able to locate and collect from borrowers when their loans become due. We reviewed data for more than 1,600 loans and determined that for almost 500 of

these loans, the borrowers' SSNs or dates of birth were incorrect in LOS. During the application process, which is separate from the loan origination process, corrections to items such as incorrect SSNs are processed in the Central Processing System (CPS); however, these corrections are not made to data in LOS. The new COD system discussed earlier may alleviate this situation. If this system works as intended, student data should be consistent among all of the department's systems, including CPS and LOS, because it will automatically share corrected data. However, until the new system is fully implemented, errors in LOS could impede loan collection efforts.

Ineffective Controls over Third Party Drafts Led to Their Elimination

As we testified in April and July 2001, significant internal control weaknesses over Education's process for third party drafts markedly increased the department's vulnerability to improper payments. Although segregation of duties is one of the most fundamental internal control concepts, we found that some individuals at Education could control the entire payment process for third party drafts. We also found that Education employees circumvented a key computer system application control designed to prevent duplicate payments. We tested third party draft transactions and identified $8.9 million of potential improper payments, $1.7 million of which remain unresolved because Education was unable to provide us with adequate supporting documentation. Education has referred the $1.7 million to the OIG for further investigation. Because of the risks we identified in the third party draft payment process, and in response to a letter from this subcommittee, Education took action in May 2001 to eliminate the use of third party drafts.

Poor Controls over Government Purchase Cards Resulted in Some Fraudulent, Improper, and Questionable Purchases

In our July 2001 testimony before this subcommittee, we described internal control weaknesses over Education's purchase card program, including lack of supervisory review and improper authorization of transactions. We found that Education's inconsistent and inadequate authorization and review processes for purchase cards, combined with a lack of monitoring, created an environment in which improper purchases could be made with little risk of detection. Inadequate control over these expenditures, combined with the inherent risk of fraud and abuse associated with purchase cards, resulted in fraudulent, improper, and questionable purchases, totaling about $686,000, by some Education employees.

During the time of our review, Education's purchase card program was operating under policies and procedures that were implemented in 1990.[9] The policy provided very limited guidance on what types of purchases could be made with the purchase cards. While the policy required each cardholder and approving official to receive training on their respective responsibilities, we found that several cardholders and at least one approving official were not trained. In addition, we found that only 4 of Education's 14 offices required cardholders to obtain authorization prior

[9]Education updated its purchase card policies and procedures in December 2001.

to making some or all purchases, although Education's policy required all requests to purchase items over $1,000 be made in writing to the applicable department executive officer. We also found that approving officials did not use monitoring reports that were available from Bank of America[10] to identify unusual or unauthorized purchases and that only limited use was made of available mechanisms to block specific undesirable Merchant Category Codes (MCC). These factors combined resulted in a lax control environment for this inherently risky program.

Education officials told us the department relied on the approving official's review of the cardholder's monthly purchase card statements to ensure that all purchases made by employees were proper. We tested the effectiveness of the approving officials' review of 5 months of cardholder statements purchase card statements. We reviewed all 903 monthly statements that were issued during these months, totaling about $4 million, and found that 338, or 37 percent, totaling about $1.8 million, were not approved by the appropriate approving official. To determine whether improper purchases were made without being detected, we requested documentation supporting the $1.8 million of purchases that were not properly reviewed. We also requested documentation for other transactions that appeared unusual. We reviewed the documentation provided by Education and identified some fraudulent, improper, and questionable purchases, which I will discuss in a moment.

We considered fraudulent purchases to be those that were unauthorized and intended for personal use. Improper purchases included those for government use that were not, or did not appear to be, for a purpose permitted by law or regulation. We also identified as improper purchases those made on the same day from the same vendor that appeared to circumvent cardholder single purchase limits.[11] We defined questionable transactions as those that, while authorized, were for items purchased at an excessive cost, for a questionable government need, or both, as well as transactions for which Education could not provide adequate supporting documentation to enable us to determine whether the purchases were valid.

We found one instance in which a cardholder made several fraudulent purchases from two Internet sites for pornographic services. The purchase card statements contained handwritten notes next to the pornography charges indicating that these were charges for transparencies and other nondescript items. According to the approving official, he was not aware of the cardholder's day-to-day responsibilities and did not feel that he was in a position to review the monthly statements properly. The approving official stated that the primary focus of his review was to ensure there was enough money available in that particular appropriation to pay the bill.

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[10]Bank of America services the purchase card program at Education.

[11]The Federal Acquisition Regulation prohibits splitting purchase card transactions into more than one segment to avoid the requirement to obtain competitive bids on purchases over the $2,500 micro-purchase threshold or to circumvent higher single purchase limits.

As a result of investigations related to these purchases, Education management issued a termination letter that prompted the employee to resign.

We identified over $140,000 of improper purchases. For example, one employee made improper charges totaling $11,700 for herself and a coworker to attend college classes that were unrelated to their jobs at the department. We also identified improper purchases totaling $4,427 from a restaurant in San Juan, Puerto Rico.[12] These restaurant charges were incurred during a Year 2000 focus group meeting, and included breakfasts and lunches for federal employees and nonfederal guests. Education, however, could not provide us with any evidence that the nonfederal attendees provided a direct service to the government, which is required by federal statute in order to use federal appropriated funds to pay for the costs of nonfederal individuals at such meetings. We have referred this matter to Education's OIG.

Other examples of improper purchases we identified include 28 purchases totaling $123,985 where Education employees made multiple purchases from a vendor on the same day. These purchases appear to violate the Federal Acquisition Regulation provision that prohibits splitting purchases into more than one segment to circumvent single purchase limits. For example, one cardholder purchased two computers from the same vendor at essentially the same time. Because the total cost of these computers exceeded the cardholder's $2,500 single purchase limit, the total of $4,184.90 was split into two purchases of $2,092.45 each. In some instances, Education officials sent memos to the offending cardholders reminding them of the prohibition against split purchases. We identified five additional instances, totaling about $17,000, in which multiple purchases were made from a single vendor on the same day. Although we were unable to determine based on the available supporting documentation whether these purchases were improper, these transactions share similar characteristics with the 28 split purchases.

We identified questionable purchases totaling $286,894 where Education employees paid for new office furniture and construction costs to renovate office space that they were planning to vacate. Only a small amount of furniture, including chairs for employees with special needs, was moved to the new building when department employees relocated.

In addition, we identified as questionable more than $218,000 of purchases for which Education provided us with no support or inadequate support to assess the validity. For $152,000, Education could not provide any support, nor did the department know specifically what was purchased, why it was purchased, or whether these purchases were appropriate. For the remaining $66,000, Education was able to provide only limited supporting documentation. As a result, we were unable to assess the validity of these payments, and we consider these purchases to be potentially improper.

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[12]The Department of Education has a regional satellite office in Puerto Rico.

After our July 2001 testimony, we issued an interim report,[13] that described the poor internal controls over purchase cards and made recommendations that the department

- reiterate to all employees established policies regarding the appropriate use of government purchase cards;
- strengthen the process of reviewing and approving purchase card transactions, focusing on identifying split purchases and other inappropriate transactions; and
- expand the use of MCCs to block transactions with certain vendors.

Recently, Education has made some changes in the way it administers its purchase card program in an effort to address these three recommendations. For example, in December 2001, the department issued new policies and procedures that, among other things, (1) establish detailed responsibilities for the cardholder and the approving official, (2) prohibit personal use of the card and split purchases to circumvent the cardholder's single purchase limits, (3) require approving officials to review the appropriateness of individual purchases, (4) establish mandatory training prior to receiving the card and refresher training every 2 years, and (5) establish a quarterly quality review of a sample of purchase card transactions to ensure compliance with key aspects of the department's policy. If appropriately implemented, these new policies and procedures are a good step toward reducing Education's vulnerability to future improper purchases.

Further, in July 2001, the department implemented a new process to approve purchase card purchases. Instead of the approving official signing a monthly statement indicating that all transactions are proper, the approval is now done electronically for each individual transaction. According to Education officials, most approving officials and cardholders received training on this new process. In order to assess the effectiveness of this new approval process, we reviewed a statistical sample of the monthly statements of cardholders for July, August, and September 2001. Purchases during these months totaled $1,881,220. While we found evidence in the department's system that all of the 87 statistically sampled monthly statements had been reviewed by the cardholder's approving official, 20 of the statements had inadequate or no support for items purchased, totaling $23,151.[14] Based on our work, we estimate[15] the most likely amount of unsupported or inadequately supported purchases during these 3 months is $65,817. The effectiveness of the department's new approval process has been minimized because approving officials are not ensuring that adequate supporting documentation exists for all purchases. In addition, these procedures do not address the problem of an authorizing official who does not have personal knowledge of the cardholder's daily activities and therefore is not in a position to know what types of purchases are appropriate.

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[13]GAO-01-1151.

[14]Subsequent to the completion of our work in this area, the department provided us with a copy of an invoice it had obtained to support one of the charges for training costing $525. According to Education officials, because the vendor does not routinely generate invoices for the training courses it provides, this invoice was not available at the time of our review. The approving official stated that she approved the charge based on a certificate of completion for the training course. This certificate was not in the file at the time of our review.

[15]Our estimate is based on a 95-percent confidence level and used a test materiality of $94,061. Based on the sample results, the amount of improper purchases could be as much as $133,895.

In response to our recommendation regarding the use of MCCs to block transactions from certain vendors, in November 2001, the department implemented blocks on purchases from a wide variety of merchants that provide goods and services totally unrelated to the department's mission, including veterinary services, boat and snowmobile dealers, and cruise lines. In total, Education blocked more than 300 MCCs. By blocking these codes, Education has made use of a key preventive control to help reduce its exposure to future improper purchases.

As we told you in our July 2001 testimony, Education took action earlier in 2001 to improve internal controls related to the use of government purchase cards by lowering the maximum monthly spending limit to $30,000, lowering other cardholders' single purchase and total monthly purchase limits, and revoking some purchase cards. This action was in response to a letter from this subcommittee dated April 19, 2001, which highlighted our April 2001 testimony, in which we stated that some individual cardholders had monthly purchase limits as high as $300,000. These and the other steps I just discussed have helped reduce Education's exposure to improper purchase card activities. However, more needs to be done to improve the approval function, which is key to adequate control of these activities.

Poor Controls Contributed to Loss of Computer Equipment

Education lacked adequate internal controls over computers acquired with purchase cards and third party drafts which contributed to the loss of 179 pieces of computer equipment with an aggregate purchase cost of about $211,700. From May 1998 through September 2000, Education employees used purchase cards and third party drafts to purchase more than $2.9 million of personal computers and other computer-related equipment. Such purchases were actually prohibited by Education's purchase card policy in effect at the time.

The weak controls we identified over computers acquired with purchase cards and third party drafts included inadequate physical controls—according to Education's OIG, the department had not taken a comprehensive physical inventory for at least 2 years prior to October 2000—and lack of segregation of duties, which is one of the most fundamental internal controls. In the office where most of the missing equipment was purchased, two individuals had interchangeable responsibility for receiving more than $120,000 of computer equipment purchased by a single cardholder, from one particular vendor. In addition, these two individuals also had responsibility for bar coding the equipment, securing the equipment in a temporary storage area, and delivering the computers to the users.[16] Furthermore, one of these two individuals was responsible for providing information on computer purchases to the person who entered the data into the department's asset management system. According to the cardholder who purchased the equipment, they did not routinely compare the purchase request with the receiving documents

[16]One of these individuals was charged in connection with a theft ring that operated during the period covered by our audit.

from the shipping company to ensure that all items purchased were received. In addition, our review of records obtained from the computer vendor from which Education made the largest number of purchase card and third party draft purchases showed that less than half of the $614,725 worth of computers had been properly recorded in the department's property records, thus compounding the lack of accountability over this equipment. Combined, these weaknesses created an environment in which computer equipment could be easily lost or stolen without detection.

In order to identify computers that were purchased with purchase cards and third party drafts that were not included in the department's asset management system, we obtained the serial numbers of all pieces of computer equipment purchased from the largest computer vendor the department used.[17] We compared these serial numbers to those in the department's asset management system and found that 384 pieces of equipment, including desktop computers, scanners, and printers totaling $399,900, appeared to be missing. In September 2001, we conducted an unannounced inventory to determine whether these computers were actually missing or were inadvertently omitted from the property records. We located 143 pieces of equipment[18] that were not on the property records, valued at about $138,400, and determined that 241 pieces, valued at about $261,500, were missing at that time.[19]

After we completed our work in this area, we again visited the office where most of the computer equipment was missing because Education officials told us they had located some of the missing inventory. Officials in this office told us that they hired a contractor to keep track of their computers when the office moved to its new space.[20] According to the officials, as part of its work, the contractor recorded the serial numbers of all computers moved and identified 86 of the 241 pieces of computer equipment that we were unable to locate during our unannounced inventory in September 2001. However, when Education staff and officials tried to locate this equipment, they were only able to find 73 of the 86 pieces of equipment. When we visited, we located only 62 of the 73 pieces of equipment. Education officials have been unable to locate the remaining 179 pieces of missing computer equipment with an acquisition value of about $211,700. They surmised that some of these items may have been surplused; however, there is no paperwork to determine whether this assertion is valid.

According to Education officials, new policies have been implemented that do not allow individual offices to purchase computer equipment without the consent of the Office of the Chief Information Officer (OCIO). However, during our previously mentioned review of a statistical sample of purchase card transactions made from July 2001 through September 2001, we found three transactions totaling $2,231 for the purchase of computer equipment without any

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[17]We attempted to obtain the invoices from another vendor. However, it did not provide this information to us.

[18]We did not attempt to find 1 piece of equipment because it was the only piece ordered by a particular office and the cardholder was not in when we did our unannounced inventory.

[19]Education's Inspector General is in the process of investigating the disappearance of these vulnerable assets.

[20]This office was in the process of moving to a new building while we were conducting our audit work.

supporting documentation from the OCIO. Based on these results, the new policies are not being effectively implemented. This is another indication that the new purchase card approval function is not fully operating as an effective deterrent to improper purchases.

In January 2002, we also reviewed the new computer ordering and receiving processes in the office where most of the missing equipment was purchased and found mixed results. These new policies are designed to maintain control over the procurement of computers and related equipment and include

- purchasing computers from preferred vendors that apply the department's inventory bar code label and record the serial number of each computer on a computer disk that is sent directly to the Education official in charge of the property records;
- loading the computer disk containing the bar code, serial number, and description of the computer into the property records; and
- having an employee verify that the computers received from the vendor match the serial numbers and bar codes on the shipping documents and the approved purchase order.

However, a continued lack of adequate physical control negates the effectiveness of these new procedures. For example, the doors to the two rooms used to store computer equipment waiting to be installed were both unlocked and unattended. The receptionist at the mail counter next to the first storage room we visited told us that he had the door open to regulate the room temperature. The Education official responsible for this process stated that he did not know that mailroom personnel had access to this room. Furthermore, he stated that he does not have a key to either storage room. Also, during our second search for this equipment, we visited four rooms where some of the computers were stored and found them all unsecured.

This lack of physical security was pointed out to the department nearly 7 weeks earlier when we first found some of its temporary computer storage rooms unsecured. The department's new written procedures state that security guards in the Washington, D.C., facilities should inspect all bags, cases, and boxes leaving the buildings to determine if they contain computer equipment, and require property passes for all equipment removed from the building. However, Education officials acknowledged that the primary focus of the building security is people and packages entering the building. Education officials told us that individuals could likely leave the building with equipment without being questioned by security. Without enhanced physical security, Education will continue to be at risk to further computer equipment losses.

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In closing, Mr. Chairman, I want to emphasize the importance of strong systems of internal control in safeguarding assets and preventing and detecting fraud, abuse, and errors. The report we are issuing today makes recommendations that, if fully implemented, will help the department improve its controls so that fraudulent and otherwise improper payments can be prevented or detected in the future and vulnerable assets can be better protected. While

Education has already taken steps to develop new policies and procedures to address the problems I have outlined today, in many cases they are not yet being effectively implemented. Vulnerabilities remain in all areas we reviewed, except for third party drafts, which have been discontinued. Until Education takes further action to strengthen its internal controls over Pell Grants, purchase cards, and computer equipment, it will continue to be susceptible to fraud, waste, abuse, and mismanagement in these areas.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other members of the subcommittee may have.

Contact and Acknowledgments

For information about this statement, please contact Linda Calbom, Director, Financial Management and Assurance, at (202) 512-9508 or at *calboml@gao.gov*. Individuals making key contributions to this statement include Dan Blair, Lisa Crye, Anh Dang, Bonnie Derby, David Engstrom, Bill Hamel, Jeff Jacobson, Kelly Lehr, Sharon Loftin, Bridgette Lennon, Bonnie McEwan, Diane Morris, Andy O'Connell, Russell Rowe, Brooke Whittaker, and Doris Yanger.

APPENDIX E -- STATEMENT OF LORRAINE LEWIS, INSPECTOR GENERAL, U.S. DEPARTMENT OF EDUCATION, WASHINGTON, D.C.

Statement of Lorraine Lewis
Inspector General
Department of Education

Before the
Subcommittee on Select Education
Committee on Education and the Workforce
United States House of Representatives

April 10, 2002

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to provide an update on the status of financial management at the Department of Education (the Department) from the Office of Inspector General (OIG) perspective. Today, I will provide: 1) an overview of the results of the Fiscal Year (FY) 2001 financial statements audits, and related recommendations, 2) an update on OIG work in purchase cards, third-party drafts, and other internal control areas and recommendations related to that work, and 3) an update on investigative activity.

I look forward to continuing to work together with the Congress and Secretary Paige to ensure that Department programs and operations serve the nation's students and taxpayers with efficiency, effectiveness, and integrity.

1. RESULTS OF THE FY 2001 DEPARTMENT-WIDE FINANCIAL STATEMENTS AUDIT

We have identified financial management on our list of management challenges of the Department for the past three years. The benefits of sound financial management are two-fold. First, sound financial management allows managers to make decisions based on reliable financial information. Second, sound financial management ensures the basic trust between a government agency and the public remains intact.

The Department has made, and continues to make, progress in this area. Last April, the Secretary created a Management Improvement Team (MIT) to focus attention on long-standing financial management issues. The MIT's mandate included such goals as addressing outstanding recommendations related to the financial statement audits and other audits from the OIG and the General Accounting Office (GAO), ensuring an environment with effective internal controls, and removing federal student aid programs from the GAO High Risk List. The MIT's October 2001 report, *Blueprint for Management Excellence* (Blueprint), includes impressive corrective action items for improving the Department's programs and operations. The Secretary has made it clear to Departmental managers that financial management must improve and has established an Executive Management Team to lead this effort. Two key players in this effort are the recently

confirmed Chief Financial Officer and the Assistant Secretary for Management. This focused attention by Department officials is key to continual progress.

The audit of the Department's financial statements for FY 2001 was conducted by Ernst & Young, LLP. My office monitored progress and completion of the work to ensure the audit complied with Government Auditing Standards, issued by the Comptroller General of the United States. Once again, we commend Ernst & Young on the professional manner in which it conducted this audit. Copies of the auditors' reports are available on our web site at www.ed.gov/offices/OIG/Areports.htm. This is the first year that Office of Management and Budget (OMB) guidance required comparative financial statements be prepared and audited. Comparative financial statements present the current year's financial information alongside previous years' financial information. The Securities and Exchange Commission has had a long-standing requirement for private sector companies to report and audit comparatively. Comparative information provides the public with more information with which to assess the operations and financial condition of the reporting entity.

Financial Statement Opinion
For the second year in a row, the Department received a qualified opinion on all five financial statements.

Report on Internal Controls
The 2001 Report on Internal Control details certain matters that are considered to be material weaknesses and reportable conditions under professional standards. There is one material weakness--financial management systems and financial reporting. There are three reportable conditions--1) financial reporting related to credit reform, 2) information systems' controls, and 3) reporting and monitoring of property and equipment. This is an improvement from the FY 2000 audit that disclosed three material weaknesses and two reportable conditions. The following is a description of the results for FY 2001.

- Material Weakness:

  Financial Management Systems and Financial Reporting (modified repeat condition). While progress has been made, the absence of a fully integrated financial management system and limitations in the process for preparing and analyzing interim and final financial statements hinders the Department's ability to accumulate, analyze, and present reliable financial information. The Department has implemented a replacement of the general ledger software package in an effort to address some of these problems.

- Reportable Conditions:

  1) *Financial Reporting Related to Credit Reform* (modified repeat condition). Credit reform issues are complex and require an effective management control structure to ensure appropriate financial presentation. The Department needs to strengthen its credit reform reporting by improving: monitoring and analysis of the underlying financial activity of its credit programs; systems, policies, and

procedures to streamline the process for preparing credit reform disclosures; and coordination of the various Department offices that oversee and account for the credit reform activity.

2) *Information Systems' Controls* (modified repeat condition). During fiscal year 2001, the Department has made progress in strengthening controls over information technology processes. However, continued effort is needed to further address control weaknesses identified by OIG, GAO, and the Department itself related to information technology and systems.

3) *Reporting and Monitoring of Property and Equipment* (modified repeat condition). The Department needs to ensure that it can adequately account for its assets. By developing and implementing Department-wide policies and procedures, it could track and safeguard property and equipment. Prior to implementing the department-wide policies, the Department must first reconcile discrepancies between annual physical inventories and internal records.

Report on Compliance with Laws and Regulations

The 2001 Report on Compliance with Laws and Regulations disclosed no instances of noncompliance with laws and regulations. As part of this work, the auditors are also required to report whether the Department's financial management systems substantially comply with certain financial system requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). The auditors noted two instances of noncompliance with the system requirements referred to in FFMIA--deficiencies in the general ledger system and the manual adjustment process, and deficiencies in systems security.

Status of Recommendations

One area that we have reported on in the past is the status of recommendations from the previous Reports on Internal Control. From FY 1995 through FY 2000, there were a total of 160 recommendations. One mission of the MIT and continuing with the Executive Management Team, is to address those recommendations. Of the 160 total, 155 are now closed. The recommendations contained in the audits of FY 1995 though FY 1998 are now closed. The audit of the FY 1999 financial statements contained 25 recommendations; all are closed except a recommendation regarding reconciliation. The audit of the FY 2000 financial statements contained 21 recommendations. Four remain open: information systems, reconciliation, reporting and monitoring of property and equipment, and credit reform accounting and monitoring.

The audit of the FY 2001 financial statements included 14 recommendations. The 14 recommendations were in the following areas: six in financial management systems and reporting, five in financial reporting related to credit reform, two in reporting and monitoring of property and equipment, and one related to information systems. The Department is preparing corrective actions plans for these recommendations.

Challenges Ahead

In the audit cycle for FY 2002, the Department faces three critical issues relating to the FY 2002 financial statements. First, the overall time to prepare and audit the Department's financial statements has been shortened by one month. OMB guidance requires FY 2002 performance and accountability reports to be issued to OMB and Congress by February 1, 2003. Second, OMB guidance requires interim financial statements. Unaudited financial statements are to be submitted to OMB by May 31, for the six-month period ending March 31, 2002. Finally, the Department will be using a new general ledger system to prepare its FY 2002 financial statements. Implementing and using a new system frequently results in additional challenges.

Implementation of Oracle Federal Financials System

In January 2002, the Department replaced its existing general ledger system with Oracle Federal Financials. We have completed audits of the development and implementation of the new system. The Department generally did not agree with the deficiencies we identified in testing, training, security, and development. The Blueprint identified Oracle implementation as a major goal, and the Department has planned steps to address shortcomings in the system. Post-implementation shortcomings may be identified by the independent verification and validation contractor the Department has engaged and continued testing by the Department. Of particular importance is the interface between the Department's Oracle system and the systems containing critical data from the office of Federal Student Aid (FSA).

2. UPDATE ON OIG INTERNAL CONTROLS WORK AND RECOMMENDATIONS

Strong internal controls are essential to the integrity of the Department's programs and operations. Our audits, inspections, and reviews have examined a number of internal controls issues and have resulted in recommendations for improvement. Our investigations also focus on areas where there is risk of fraud and abuse due to weak internal controls. In addition, GAO's oversight work has provided important findings and recommendations relating to questionable third-party drafts, purchase cards, and Pell grant disbursements, for example. Given the scope of the Department's programs and operations, and the amount of federal funds involved, GAO's work in identifying fraud and improper payments has provided invaluable supplemental resources to our oversight efforts. We have supported its efforts and shared our work with GAO.

The Secretary has made an effective system of internal controls a top priority. The Blueprint contains plans to strengthen the control environment in the Department. The Secretary has also spoken to all Department employees about the importance of having a culture of accountability, convened a Department-wide group to foster this culture throughout the entire Department, and charged his Executive Management Team to lead this effort. Recently, he required that all Department employees must complete on-line internal controls training by April 30, 2002. In addition, OIG representatives have provided advice on internal controls training for managers and supervisors conducted by the Department.

Our reports have identified weaknesses in controls over purchase cards, third-party drafts, cellular phones, the contract payment process, and government equipment, for example. Although the Department has made progress by eliminating the use of third party drafts, as one example, more improvements are needed.

Travel Cards

We have recently completed an audit of travel card use. Current Department policy requires all employees who travel more than once a year to apply for an individually billed travel card. We found that: cardholders made purchases and ATM withdrawals for personal use, made excessive ATM withdrawals, and did not always use their cards when required. We referred the cases of employees who used cards improperly to their principal offices for appropriate administrative action. Our investigators are examining cases where there was evidence of possible fraudulent activity. We recommended several changes to address these deficiencies including implementation of guidelines to monitor travel card activity, employee training, and immediate cancellation of cards held by persons who left the Department. Based on our findings, the Department has initiated several corrective actions to address our recommendations; more corrective actions are planned.

Purchase Cards

In 2000, at the Department's request, we reviewed its internal controls over the use of purchase cards. We found that, while the Department had established procedures to ensure the financial integrity of the purchase card program, these procedures were not always current and were not always followed. We reviewed and tested controls in each principal office. At the conclusion of each review, we met with the head of the office and discussed results and actions he or she should take to improve controls. We also issued a capping report to the then Deputy Secretary with 22 recommendations to strengthen the control environment, provide an assessment of internal and external risks, strengthen control activities, strengthen information and communication over the use of cards, and strengthen monitoring over card use. The Department established 27 action items to address our recommendations, and these items have all been closed.

We recently completed a follow-up audit on controls over purchase cards. We found that while the Department has taken action to address the internal control weaknesses identified in prior OIG reviews over purchase cards, more improvements are needed to discourage abuse of these cards. We recommended the Department develop internal control review guidelines and conduct on-site internal controls reviews (reviews conducted at locations where the purchase card activity and approval are performed). We also recommended that the Department reassess the number of cardholders assigned to each approving official.

The Department concurred with our recommendations and has planned steps to address these recommendations. The Office of the Chief Financial Officer (OCFO) has developed guidelines to conduct testing of purchase card transactions both on-site and through documentation submission. The OCFO also advised us that it will continue to work with program offices to realign approving officials and cardholders to a manageable level. Finally, the OCFO apprised us that it will require training for newly appointed approving officials.

Based on our experience inspecting and auditing the Department's purchase card program, we volunteered to develop a guide for use by auditors and inspectors in conducting reviews of an agency's government purchase card program. We plan to distribute the guide throughout the Inspector General community by the end of this month.

Records Management

The maintenance of records is essential to a good internal control environment. Records provide the necessary documentation needed to support decisions, be they policy decisions or financial decisions. The Federal Records Act requires federal agencies "make and preserve records containing adequate and proper documentation of the organization, functions, policies, decisions, procedures, and essential transactions of the agency." There are also other laws that address records management requirements for both paper and electronic records, such as the Paperwork Reduction Act, the Freedom of Information Act, and the Government Paperwork Elimination Act. Because of the importance of records management, we have also examined the Department's electronic and paper record management policies and procedures. We found that records liaison officers lacked appropriate records management training, and that principal offices are not disposing of records properly. We recommended that the Department develop more specific records management guidance and policies, provide additional records management training, and determine whether principal offices are using proper storage facilities.

The Department developed a corrective action plan to address our recommendations. One of fourteen action items, development of a records management training program, has been closed to date. We will continue to monitor the Department's records management program.

Contract Monitoring

We recently completed an audit of the Department's controls over government property provided under FSA contracts. We evaluated controls at three FSA contractors and found that these contractors were not appropriately accounting for government property. Specifically, we found that contractor records were inaccurate and incomplete, equipment was not properly identified, and some purchases were not utilized and disposed of on a timely basis.

We recommended that FSA develop and implement a plan for monitoring government property that includes a clear definition of responsibilities, reconciliation of purchases of government property with contractor records, and compliance with Federal Acquisitions Regulation requirements. The Department concurred with our findings and recommendations.

Information Technology Security

Another component of internal controls is strong information technology (IT) security. As more of the Department's programs rely on automated processes, it becomes more critical that the Department's systems are capable of ensuring the availability, confidentiality, and integrity of the data they contain. The information systems used to administer government funds should be secure from unauthorized access, intrusion, disruption, and loss. The importance of IT security is also heightened by the mandate to expand electronic government contained in the President's Management Agenda.

The Department has recognized the importance of IT security and has initiated a number of actions to strengthen security. The Blueprint focused on better management of information technology and set specific goals and timetables for strengthening IT security. The Department also identified over 600 security weaknesses and indicated that it corrected more than 120 of these weaknesses. In addition, the Office of the Chief Information Officer has conducted two security day events designed to increase security awareness throughout the Department.

Federal Student Aid Programs

In federal student aid programs, our work and the GAO's has also revealed the need for better internal controls in the area of accurate data exchange among the systems that operate these programs. During GAO's work on improper payments, it referred to our office seven schools, two of which we were already investigating, which seemed to have a high percentage of Pell Grant recipients over age 70. Those investigations are still pending.

We are also involved in data-mining activities by looking at data in the Free Application for Federal Student Aid (FAFSA) and records in the National Student Loan Data System (NSLDS). The FAFSA is the vehicle used by the Department for applicants applying for federal student aid. NSLDS data is submitted from a number of sources: guaranty agencies, Pell grant program, schools, and debt collections. It is critical that this data is valid, reliable, and timely.

We previously performed audit work on overawards of federal student aid by negotiating a matching agreement with the Internal Revenue Service (IRS). For that audit, we matched income reported on the FAFSA to income reported to the IRS. Based on our results, we recommended, and the Department concurred, that it match income data provided on the FAFSA with IRS data to help prevent overawards of student aid funds. The Higher Education Act Amendments of 1998 provided some authority for the verification of income. The Department has performed two sample matches with IRS, and continues to work with IRS and OMB to address further legislative changes for a permanent match. This legislative authority is requested in the President's FY 2003 budget request. We recommend that Congress pass such legislation.

The need for this match was again highlighted in March 2001 when, in just one investigation, 26 people were charged with fraudulently obtaining more than $2.6 million from the Department in the form of grants, work-study, and loans. To date, 25 people have pled guilty. Our work in these cases also led to over $2.8 million in civil settlements and judgments. A data match of income information with IRS might have prevented these ineligible awards.

While no set of internal controls can guarantee that mistakes will not happen or persons intent on committing fraud will not succeed, we continue to recommend that greater program monitoring and enforcement should be done by FSA to protect the integrity of the programs. Last year, we issued three audit reports that cited significant deficiencies in FSA's oversight of schools in the areas of program reviews, tracking and resolving audit recommendations, and recertifying foreign schools. Corrective actions are not yet completed on these audits. We recently issued an audit report that found FSA had not sufficiently monitored the financial responsibility of schools. We also audit higher education institutions directly. We have recommended that FSA take the necessary actions to address compliance problems at schools that we have audited, including

seeking repayment of funds where appropriate. These reports and others may be found on our website: http://www.ed.gov/offices/OIG/.

Our work also continues to show that the Federal Family Education Loan Program is vulnerable to fraud when individuals who claim to be enrolled in a foreign school are not actually enrolled. We have recommended that FSA require a verification of the borrower's enrollment in a foreign school prior to disbursement of federal funds.

3. UPDATE ON CERTAIN OIG INVESTIGATIONS

We are nearing completion of several investigations of criminal activity involving Department employees and others. We will continue to work with the FBI, the Department, GAO, and others to seek prosecution of criminal actions and to deter others from seeking to defraud the Department.

Telecommunications Case

Since 1999, we have been conducting an investigation of a major fraud scheme involving 19 individuals, including eight Department employees. Elizabeth Mellen, the contracting officer representative for a contract the Department had with Bell Atlantic, ordered numerous items for her personal use and for the use of several family members, some of whom were Department employees. She also fraudulently authorized overtime pay to a Bell Atlantic (now Verizon) and a Lucent Technology technician. Ms. Mellen's actions, and those of others, defrauded the government of more than $300,000 in property including computers, printers, scanners, cordless phones, and a 61-inch television. In addition, more than $700,000 in false overtime was charged to the Department.

To date, 15 defendants, including seven Department employees, have pled guilty, and one individual went to trial on this wide-ranging conspiracy and was recently found guilty of three charges--one count of conspiracy and two counts of theft of government property. The remaining three defendants are scheduled to go on trial later this year.

Impact Aid

Last year, three individuals were indicted for conspiring to illegally receive, conceal, and retain stolen property using $1.9 million in Impact Aid funds. In January 2002, two of these individuals were arrested; we are working with the FBI to locate and arrest the third individual. Our efforts to date resulted in the return of approximately $1.7 million in Impact Aid program funds to the Department.

Puerto Rico

We have extensive investigative and audit work involving the Puerto Rico Department of Education. We found that the Puerto Rico Department of Education (PRDE) awarded five Title I fixed-price contracts to National School Services of Puerto Rico without full and open competition. PRDE also did not determine each line item of cost included in the fixed-price contract. For this reason, PRDE and the Department could not be assured that the highest quality services and products were received at competitive prices or whether certain vendors were given

preferential treatment or arbitrarily excluded. Moreover, resources used to pay unreasonable amounts could have been used for other projects or for learning centers at needy elementary schools, as provided for the terms of the contract.

Our subsequent investigation of the Puerto Rico Department of Education led to the indictment and arrests of 17 individuals, including the former Secretary of Education for Puerto Rico, for several felony charges including extortion, program fraud and money laundering. The indictment alleged that defendants conspired to extort more than $4.3 million from contractors. These defendants were taking money for their personal use and were providing money to their political party. Guilty pleas by the former Secretary of Education for Puerto Rico, Associate Secretary of Education, a contractor who is a relative of the former Secretary, and another contractor provided for a $2.9 million forfeiture--$1.3 million in cash and $1.6 million in property and cash-- to the U.S. Government.

Purchase Cards

Our ongoing investigation related to fraudulent purchase card use recently led to guilty pleas by two employees of a private furniture vendor, Aaron Rents. These individuals conspired with a Department employee and facilitated the use of a government credit card to purchase household furniture for the personal use. The charging documents stated the vendor's employees concealed the true nature of these purchases by falsely invoicing the government for the purchases of office furniture.

Our work will continue to reflect our commitment to promoting the efficiency, effectiveness, and integrity of the Department's programs and operations.

This concludes my statement. I would be happy to answer any questions that you may have.

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