UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

MAR - 1 2002

Honorable Roderick Paige
Secretary of Education
Washington, D.C. 20202

Dear Mr. Secretary:

The enclosed reports present the results of the audits of the Student Financial Assistance financial statements for the fiscal years ended September 30, 2001 and 2000, to comply with the Higher Education Act Amendments of 1998. The reports should be read in conjunction with the financial statements and notes of the Student Financial Assistance to fully understand the context of the information contained therein.

The Office of Inspector General (OIG) contracted with Ernst & Young, LLP, Certified Public Accountants, to perform the audits. The OIG monitored the progress and completion of the work to ensure compliance with *Government Auditing Standards*.

The results of the audits were discussed with Student Financial Assistance officials throughout the audits. The Student Financial Assistance and the Office of the Chief Financial Officer responded to the findings and recommendations presented in the draft reports and changes were incorporated as appropriate.

During the course of the audits, Ernst & Young, LLP, identified other matters which are not reportable but nevertheless warrant management's attention. These are being communicated in a separate letter for management's consideration.

In accordance with the Freedom of Information Act (Public Law 90-23), reports issued by the OIG are available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

We appreciate the cooperation given us and Ernst & Young, LLP, during the audits.

Sincerely,

Lorraine Lewis

Enclosures

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF INSPECTOR GENERAL

THE INSPECTOR GENERAL

MAR - 1 2002

Greg Woods
Chief Operating Officer
Student Financial Assistance
Washington, D.C. 20202

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ASSURANCE AND ADVISORY BUSINESS SERVICES

AUDITED FINANCIAL STATEMENTS

U.S. Department of Education

Student Financial Assistance

Years Ended September 30, 2001 and 2000

ERNST & YOUNG

ERNST & YOUNG LLP

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Report of Independent Auditors

ERNST & YOUNG LLP

1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

Phone: 202 327 6000

Report of Independent Auditors

To the Inspector General
U.S. Department of Education

We have audited the accompanying consolidated balance sheets of the Student Financial Assistance (SFA), a performance-based organization of the U.S. Department of Education (the Department), as of September 30, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing for the fiscal years then ended. These financial statements are the responsibility of SFA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We have identified certain aspects of SFA's financial reporting process as material weaknesses in internal control during fiscal years 2001 and 2000. The account analysis and reconciliation processes used by SFA have not been fully effective in compensating for these material weaknesses. As a result, during fiscal years 2001 and 2000, SFA has revised the opening balances in its previously issued financial statements for fiscal years 2000 and 1999, as described in more detail in Notes 13 and 14 to the financial statements. We were unable to obtain sufficient evidence or to otherwise satisfy ourselves as to the accuracy or completeness of these adjustments. In addition, the Department was unable to provide adequate documentation to support certain amounts reported in the consolidated balance sheets. Such amounts include approximately $827 million and $267 million in total assets, $396 million and $107 million in total liabilities and net position for fiscal years 2001 and 2000, respectively, that require further analysis and investigation to determine if such amounts are applicable to SFA's financial statements and have been recorded properly. The results of such analysis and investigation could result in the identification of additional adjustments to the financial statements.

In our opinion, except for the effects of such adjustments to the consolidated balance sheets, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing, if any, as might have been determined to be necessary had we been able to examine sufficient evidence regarding the adjustments and amounts referred to in the preceding paragraph as of and for the years ended September 30, 2001 and 2000, the consolidated balance sheets and related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing referred to above present fairly, in all material respects, the financial position of SFA as of September 30, 2001 and 2000, and its net cost, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended in conformity with accounting principles generally accepted in the United States.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The information presented in the Management Discussion and Analysis of SFA and the Supplemental Information is not a required part of the basic financial statements, but is supplementary information required by Office of Management and Budget Bulletins No. 97-01, as amended, and No. 01-09, as applicable, *Form and Content of Agency Financial Statements*. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and accordingly, we express no opinion on it.

In accordance with Government Auditing Standards, we have also issued our reports dated February 4, 2002, on our consideration of SFA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations. Those reports are an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audits.

Ernst + Young LLP

February 4, 2002
Washington, D.C.

Section II

Report on Internal Control

ERNST & YOUNG LLP

1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

Phone: 202 327 6000

Report on Internal Control

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheets of the Student Financial Assistance (SFA), a performance-based organization of the U.S. Department of Education (the Department), as of September 30, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing for the years then ended, and have issued our report thereon dated February 4, 2002. That report noted certain matters that resulted in a qualification of our opinion on the consolidated balance sheets, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing.

Except for the matters discussed in the third paragraph of the Report of Independent Auditors, we conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered SFA's internal control over financial reporting by obtaining an understanding of SFA's internal control, determined whether this internal control had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal control relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Management is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that: assets are safeguarded against loss from unauthorized use or disposition; transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting principles generally accepted in the United States; and data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information. Because of inherent limitations in any internal control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In addition, with respect to internal control related to performance measures reported in the Management Discussion and Analysis of SFA's consolidated and combined financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

We noted certain matters involving internal control and its operation that we consider to be reportable conditions under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 01-02. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. The remainder of this report details the reportable conditions, the first of which is considered a material weakness as defined above.

SFA relies on the Department's Office of Chief Financial Officer (OCFO) to provide support for SFA's financial reporting needs. Specifically, SFA has a memorandum of understanding (MOU) with OCFO that indicates that OCFO is responsible for the following: (1) preparing SFA's financial statements; (2) performing the daily operations of processing transactions in the general ledger; (3) preparing the required financial reporting to the Office of Management and Budget and the U.S. Department of the

Treasury, such as the SF-133 and the SF-224; and (4) developing and distributing accounting policies and procedures.

In addition, under the MOU, SFA is responsible for: (1) implementing accounting policies and procedures; (2) coordinating with OCFO and Budget Service on all financial reporting issues; and (3) reconciling subsidiary ledgers to supporting documentation and ledgers. SFA is in the process of developing and implementing a fully functional financial management system to better facilitate its reconciliation processes that will be integrated with the Department's general ledger.

MATERIAL WEAKNESS

1. Financial Management Systems and Financial Reporting Need to Be Strengthened (Modified Repeat Condition)

Background

The Chief Financial Officers (CFO) Act and, in particular, OMB Bulletin No. 97-01, as amended, and No. 01-09, as applicable, *Form and Content of Agency Financial Statements*, require that financial statements be the culmination of a systematic accounting process. The statements are to result from an accounting system that is an integral part of a total financial management system containing sufficient structure, effective internal control, and reliable data. The Department and SFA rely on a variety of work-around procedures to prepare financial statements, including significant manual adjustments, due to deficiencies in the current general ledger system and the lack of a fully integrated financial management system.

Significant Progress Noted, but Additional Improvement Needed

Although this material weakness from prior years remains outstanding, SFA has made improvements to its financial reporting process and financial management activities during fiscal year 2001. For example, SFA:

- Participated in the Management Improvement Team (MIT) formed at the direction of the Secretary of Education. The team was tasked to "develop a blueprint for management excellence at the Department." The blueprint describes the Department's commitment to management improvement and establishes a roadmap for these improvements and mechanisms for achieving accountability and performance throughout the Department.

- Worked with the Department in performing Grant Administration and Payment System (GAPS) subsidiary to Financial Management System Software (FMSS) general ledger reconciliations on a monthly basis. In performing these reconciliations, the Department was able to identify errors and discrepancies in a more timely manner than in prior years. Additionally, the monthly reconciliations enhanced their ability to research and resolve differences that reduced the possibility of numerous material differences existing at year-end.

- Worked with the Department in preparing monthly financial statements beginning in May 2001, which helped SFA to identify areas needing further study.

- Performed detailed analysis of certain general ledger account balances in an effort to correct unresolved differences that existed in prior years and correct deficiencies in the postings of certain current year transactions to the existing general ledger system. Specifically, the Department and SFA performed procedures to align Direct Loan and Federal Family Education Loan (FFEL) subsidiary records and the FMSS general ledger, align budgetary sources and uses, and remove unmatched transactions from the undelivered orders and Fund Balance with Treasury account balances.

While progress has been made, significant financial management issues continue to impair SFA's ability to accumulate, analyze, and present reliable financial information. These weaknesses are primarily due to the absence of certain components of a fully integrated financial management system. Specifically, FMSS is not used to produce a general ledger trial balance at the reporting group level or at a consolidated level, and certain transactions continue to be recorded in FMSS to incorrect general ledger accounts. Consistent with the prior years, the Department relies on manual adjustments to correct discrepancies and an automated tool to assist in consolidating and reporting financial results. The Department continues to compile the financial statements through a multi-step process using a combination of manual and automated procedures. These processes increase the risk that errors may occur in the financial statements. To address the weaknesses identified with FMSS, the Department is implementing a replacement for the general ledger software package which management indicates began processing transactions in January 2002. In addition, SFA is implementing a financial management system to support its financial management and reporting needs that will be integrated with the Department's general ledger. Management indicates the new SFA system began processing transactions in October 2001. We continue to believe that until a new financial management system is fully operational, working effectively, appropriately supported, and adequately integrated with the Department's system, additional focus on financial reporting is needed. In addition, operational changes should be considered to further integrate the financial statement close process as part of the overall financial management system.

The following provides examples of issues encountered during our review of SFA's financial statements and the related process surrounding the preparation of its financial statements:

General Ledger

As a result of performing various account analysis and account reconciliations, consistent with the prior year, SFA recorded numerous restatements and reclassifications related to prior fiscal year financial statement balances. Within the Fund Balance with Treasury reconciliation, we noted that approximately $258 million related to the FFEL program and $206 million related to the Direct Loan program were reclassified to other governmental assets and accounts payable from Fund Balance with Treasury and cash and other monetary assets. Management is continuing to research the appropriate treatment of the related transactions. Additionally, SFA made a reclassification of approximately $743 million that was included in the fiscal year 2000 Payable to Treasury balance to the Loan Guarantee liability in fiscal year 2001. The continuation of restatements and reclassifications of prior year results as discussed in the credit reform section of the report, results from additional analysis performed by management but also reinforces concerns about the lack of an integrated financial management system and SFA's ability to report accurate and timely financial data.

Consistent with the prior year, SFA performed extensive analysis of certain general ledger account balances during fiscal year 2001 in an effort to resolve errors that existed in prior years. In addition, weaknesses existed during FY 2001 in the FMSS Document Type Standard Accounting Event (DOC SAE), which is a set of accounting code combinations used to facilitate correct posting. These weaknesses were also addressed through manual entries prepared by the Department. As a result of these procedures, a number of manual adjustments were made to correct balances reported in the general ledger. Adequate historical records were not always available, so in some cases adjustments were made based on the best available data and management's reasoned judgment as to the most likely cause of the discrepancies. While this adjustment process appears to have been pragmatic given the circumstances, management was unable to provide sufficient documentation to support these adjustments. For example, we noted that SFA restated prior year unobligated balances, obligated balances, and obligations incurred by $30 million, ($152) million and $154 million respectively. Additionally, management determined that various items of income and expenses recorded in fiscal year 2001 were actually incurred during the prior fiscal years. Therefore, prior period adjustments of approximately $(48) million were made to remove these items from current year income and expenses and reflect them in balances for net position. In many instances, the support for these adjustments consisted of journal voucher coding sheets. We also noted errors in certain manual adjustments that had been processed and approved by management. These errors resulted in additional manual adjustments being posted to the financial statements to correct errors made in other manual adjustments, calling into question the sufficiency of the adjustment preparation, review, and approval process. In addition, the use of manual adjustments increases the risk that errors and irregularities may occur.

During fiscal year 2001, we noted that unsupported differences remain in the subsidiary records and the general ledger records. For example, the Fund Balance with Treasury contains numerous unreconciled (unmatched) schedules between the general ledger (FMSS) and Treasury (6654) records. As explained earlier, the differences between the general ledger and Treasury records were reclassified as a $258 million increase to other governmental assets and a $206 million increase to accounts payable at year-end. The budget clearing account (91F3875) reflects a net debit balance of approximately $145 million, while the suspense account (91F3885) reflects a net debit balance of approximately $44 million as of year-end. At year-end, the accounts payable balance included certain disbursement-in-transit amounts that have not cleared the account since June 2001. In addition, approximately $14 million of disbursements-in-transit were not confirmed by Treasury as of October 2001. Although management indicates that the activity in these accounts relate to reclassifications of amounts between appropriations and timing differences, the documentation provided to support these differences was not sufficient. Management has not yet determined the final resolution of these amounts.

Financial reporting is a key management control. OMB Circular A-123, *Management Accountability and Control*, defines management controls as "the organization, policies, and procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making." Given the system weaknesses identified above, SFA needs to strengthen its financial reporting in order to ensure full compliance with OMB Circular A-123.

Financial Statement Preparation

SFA prepared interim financial statements starting in May 2001 and prepared some interim financial information at earlier dates. However, these statements were not fully useful in presenting accurate and timely financial results. The draft financial statements as of June 30, 2001, which we understand due to time constraints were provided to us without having first been reviewed by management, contained financial statement line items that were not adequately reconciled or supported. Management ultimately concluded that further work to refine the June 30, 2001 financial statements should not be performed in order to focus additional account analysis on subsequent months. Beginning in FY 2002, the Department will be required to submit interim financial statements as part of the requirements of OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements.* While lessons learned from preparing interim and year-end financial statements will be useful in strengthening SFA's process, there will be critical operational challenges that must be resolved in order to prepare accurate information on an interim basis in FY 2002.

The financial statements initially provided to us for the year ended September 30, 2001, had line items with balances different from that which would normally be anticipated. For example, initially, cash and other monetary assets on the balance sheet reported a balance of approximately $286 million. These amounts were originally reclassified from Fund Balance with Treasury to cash and other monetary assets during FY 2001. However, the amounts did not represent cash and were subsequently reclassified. The majority of these amounts, approximately $258 million, were reclassified to other governmental assets as an unexplained difference. Additional adjustments were made to the financial statements to correct line items that reflected balances different than anticipated, as discussed in the credit reform section of the report. We noted that the initial version of the financial statements contained mathematical errors in various notes to the financial statements, certain amounts that did not agree from the financial statements to their related notes, and certain FY 2000 amounts that did not agree to the audited prior year amounts. Based on further review and account analysis, management determined that certain account balances were not accurate. As a result of correcting entries identified, over 40 account balances in the primary financial statements changed between the first and second versions provided for audit.

OMB Circular A-123 states: "Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. The documentation for transactions, management controls, and other significant events must be clear and readily available for examination."

Additional Compensating Controls Need to be Strengthened

The U.S. General Accounting Office's *Standards for Internal Control in the Federal Government* states that internal control activities help ensure that management's directives are carried out. The control activities should be effective and efficient in accomplishing the agency's control objectives. Examples of control activities include: top level reviews of actual performance, reviews by management at the functional or activity level, segregation of duties, proper execution of transactions and events, accurate and timely recording of transactions and events, and appropriate documentation of transactions and internal control.

Because significant weaknesses exist in the general ledger system, management must compensate for the weaknesses by implementing and strengthening additional controls to ensure that errors and irregularities are detected in a timely manner. Management has taken additional steps to compensate for system weaknesses, but further efforts are needed as discussed below.

Account Analysis and Reconciliations

Management's procedures for account analysis and reconciliations are improving. We noted improvements for fiscal year 2001, such as the analysis of general ledger account balances performed by SFA and performance of the GAPS to FMSS reconciliations noted earlier. However, we noted additional room for improvement. As a result of our audit and management's subsequent review of general ledger balances, various manual adjustments were made to reclassify and adjust the account balances reported in the financial statements and related notes to the financial statements. Had SFA and OCFO performed more effective periodic analysis of the general ledger accounts, these errors could have been identified and corrected by management. Additional issues with respect to reconciliations and account analysis related largely to FFEL activity are discussed in greater detail in the section of the report regarding credit reform. While it was noted that the Department did not identify financial reporting related to credit reform as a material weakness in its Financial Managers' Financial Integrity Act (FMFIA) report for fiscal year 2001, reconciliations were identified as a material weakness.

Review for Improper Payments

We have been informed by management and the Office of Inspector General (OIG) of several instances of improper payments, including duplicate payments. Management indicated that there were two known immaterial instances of duplicate or erroneous payments during fiscal year 2001. The funds have been accounted for in these instances and appropriately reflected in the financial statements. Management also identified additional immaterial instances of erroneous payments made in prior years that were recovered in 2001.

It is our understanding that the Department and SFA are cooperating in ongoing General Accounting Office (GAO) and OIG projects to identify improper payments and to review controls surrounding the disbursement process. That work has identified a number of potential improper payments, missing computer equipment, improper Pell Grant awards, and inappropriate travel and purchase disbursements. We understand that management reduced the number of employees with access to purchase cards, reduced certain purchase card spending limits, and eliminated the use of third party drafts during fiscal year 2001. Investigations of grantee, lender guaranty agencies and educational institutions, and improper payments also inform SFA's process to refine its internal control. We believe efforts to learn from these projects and refine controls are critical in reinforcing the Secretary's initiative to become a world class financial management organization.

Rigorous Review of Interim Financial Statements

During fiscal year 2001, SFA began producing financial statements on a monthly basis and faced many challenges in preparing such information. As noted earlier, many of the year-end and monthly financial statement balances contained errors that required subsequent correction. The information provided by interim financial data should enhance management's ability to make informed decisions about corrective action steps that may be required to achieve desired financial and non-financial results. Building on SFA's emerging account analysis processes, accurate interim financial information can help identify areas meriting specific focus.

Recommendations:

We recommend that Student Financial Assistance perform the following:

1. Ensure that the new financial management system is working effectively and adequately integrated with the Department's new system. Integrate the financial statement close process as part of the overall financial management system.

2. Assign reconciliation and analysis preparation and review responsibilities and define approaches to corroborate account balances for all significant accounts on a monthly or more frequent basis as appropriate.

3. Coordinate with the Department to review and enhance policies and procedures surrounding the preparation and review of adjustments, ensure that adequate and sufficient supporting documentation accompanies each adjustment throughout the approval process, and provide training to ensure that individuals preparing and reviewing the adjustments receive sufficient guidance to meet financial reporting objectives.

4. Coordinate with the Department to further implement data mining and other approaches as recommended by the MIT to search for duplicate payments and research improper payments that are identified and continue to refine internal controls in response to such efforts.

5. Coordinate with the Department to resolve unreconciled differences specific to the disbursements-in-transit, budget clearing, and suspense accounts on a timely basis, and resolve the unreconciled variances currently reflected in other governmental assets and accounts payable.

6. Coordinate with the Department to assess the roles and responsibilities of each Departmental office (including OCFO, SFA, and Budget Service) involved with the financial reporting process to ensure that appropriate resources and tools are available to achieve the financial reporting objectives established by management, particularly when competing duties such as staffing the MIT and implementing a new accounting system strain resources.

REPORTABLE CONDITIONS

2. Improvement of Financial Reporting Related to Credit Reform Is Needed (Modified Repeat Condition)

The Federal Credit Reform Act of 1990, as amended, was enacted to require agencies to more accurately measure an agency's cost of federal loan programs. As part of implementing the requirements of the Credit Reform Act, agencies are required to estimate the net cost of extending credit over the life of a direct loan or guaranteed loan based on the present value of estimated net cash flows, excluding certain administrative costs. As a result of our testing, we noted that the management controls surrounding the calculation and reporting of the loan liability activity and subsidy estimates could be improved. OMB Circular A-123 defines management controls as "the organization, policies, and procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making."

During our testing of loan guarantees, allowance for subsidy, and subsidy costs estimates, we noted the following items that indicate management controls need to be strengthened:

- The Department and SFA prepared comparative financial statements for the first time during the fiscal year ended September 30, 2001, in accordance with the requirements of OMB Bulletin No. 01-09. As a result of this process, inconsistent and unexpected variations were noted in balances disclosed in financial statement note 4, "Credit Program Receivables and Liabilities for Loan Guarantees." For example, the "Components of Subsidy Transfers" indicated that fees to be collected for Direct Loans would result in an increase in the "Current Year Subsidy Transfers from Program Account." This is the opposite result that would be expected from the collection of fees. Upon further research, it was noted that the financial statement disclosures for "Components of Subsidy Transfers" merited additional review. Amounts disclosed for: (1) interest rate differential, (2) default, net of recoveries, (3) fees, and (4) other were initially incorrect in the prior year financial statements and the FY 2001 draft financial statements prepared by SFA. The total amount reported for "Current Year Subsidy Transfers" did not require revision. In addition, we also noted differences between the amount of FFEL loans receivable reported in the general ledger and amounts reported by guaranty agencies. While much of the difference may be appropriately accounted for in the allowance for loss, a net unexplained difference of approximately $300 million remained. SFA attributed this difference to timing and definition differences, as well as potential data quality issues at the guaranty agencies. We also noted that while the Department's reconciliations ensure that FFELP activity is posted into the general ledger, data in the general ledger is not adequately traced back to the subsidiary listings.

- During the analysis of the Allowance for Subsidy for Post-1991 FFEL loans, a negative (debit) balance was presented in the prior year and the current year draft financial statements. This would indicate that SFA was projecting to receive principal and interest in excess of the face amount of all such loan receivables. The Post-1991 FFEL loans have been in default for an extended period of time and have been returned to SFA under the reinsurance provisions of the FFEL loan program. Upon further review, it was determined that the calculation approach for the Allowance for Subsidy needed to be revised to account for the default subsidy rate inherent in the credit model calculation applicable to such loans. Based on this review, a $3.6 billion reclassification adjustment was required to increase the Allowance for Subsidy (return the balance to a true credit) and reduce the Liabilities for Loan Guarantees in fiscal year 2000.

- During fiscal year 2001, SFA implemented the requirements of Statement of Federal Financial Accounting Standards (SFFAS) No. 18, "Amendments to Accounting Standards For Direct Loans and Loan Guarantees – SFFAS No. 2." SFFAS No. 18 requires that the disclosures for direct loans and loans guarantees be expanded significantly by adding the following requirements: (a) report subsidy re-estimates in two components: interest rate re-estimates and technical/default re-estimates, (b) display in a note to the financial statements a reconciliation between the beginning and ending balances of loan guarantee liability and the subsidy cost allowance for direct loans, and (c) provide disclosure and discussion for changes in program subsidy rates, subsidy expense, and subsidy re-estimates. As result of these requirements, SFA is required to aggregate the activity that flows through the Allowance for Subsidy for Direct Loans and Liability for Loan Guarantees for FFEL Loans into specific categories. During this process it became apparent that the Department and SFA should develop additional systems, policies and procedures to streamline the process for developing these disclosures and assuring the accuracy of the data disclosed. Further, we noted that monitoring of the information that flows through this account should be improved, with cash flows reconciled to guaranty agency and other subsidiary systems and validated through comparisons to subsidy model estimates, and any variances investigated.

- Budget Service is responsible for managing SFA's program budget, policy, and legislative development, which includes calculating the subsidy costs associated with the Department's loan programs. It is still unclear as to which organization within the Department (OCFO, SFA, and Budget Service) is monitoring the activity of the general ledger accounts, performing routine reconciliations of account activity to loan program systems or extracts, preparing supporting documentation for adjustments, or providing the explanations with regard to changes that occur from one year to the next year in the loan liability estimate and in all FFEL-related budgetary and proprietary accounts. Without formalized written policies and procedures documenting each aspect of the estimation process, and without the use of quality assurance and validation checks for all aspects of the estimation process, SFA increases its risk that the estimation process may not be performed in a consistent manner, thereby increasing the likelihood for errors to occur. In light of interrelationships between activity reflected in the accounting and loan subsidiary records and amounts used in the development and recording of subsidy estimates, each of the above organizations must understand the subsidy estimation process, and the inputs to SFA's records, to ensure that the financial reporting and model estimating processes are appropriately executed in order to achieve management's objectives. Ultimately, the OCFO is responsible for the preparation of the financial statements for the Department and SFA, so it must have a clear understanding of how credit subsidy estimates are recorded, verified, accumulated, and disclosed. We note that in connection with the Secretary's "Blueprint for Management Excellence" action plan, a Department/OMB Student Loan Audit Modeling Working Group has been designated by the Department.

- The long-term cost for the FFEL loan program is reflected in the financial statements as liabilities for loan guarantees. The Department uses a computer-based cash flow projection model and OMB calculator to calculate subsidy estimates related to the program that are then recorded in the liability account. The model uses multiple sources of loan data and hundreds of assumptions. Also reflected in the liability account is the FFEL loan activity for such items as interest supplement payments, claim payments, and fee collections. The high volume of activity, multiple sources of data, and sensitivity of assumptions used to record subsidy cost, subject the liability account to a significant level of inherent risk of misstatement. Additional detect controls and analytical tools should be used to evaluate the accuracy of the account balance. The current cash flow model has the capability to forecast the future liability for FFEL loans at a given point in time. This calculation can be used to benchmark if both the model and account balance are in approximate proper alignment for anticipated future costs. Significant differences noted would help indicate whether potential improper amounts were flowing through the liability account or the model was improperly forecasting future costs. Also, the model can project future guarantee costs by major activity. Analytical reviews of each activity component can be prepared to test the reasonableness of the total ending liability. Our audit process included a number of discussions with Budget Service that may form the initial underpinnings of such an approach.

- SFA does not have significant history of repayment data or historical trend analysis available to support the assumptions used for defaults, repayments, and other cash flows for loans that have been classified as consolidated. In addition, SFA is not easily able to identify all cash flows related to consolidations in order to sufficiently develop the payment history of these loans. While not readily quantified by management, the cash flows from consolidations can have a significant role in the re-estimate process. Further, the number and dollar amount of consolidated loans has increased significantly in the last few years. Early identification of trends, particularly in moving borrowers between the FFEL and Direct Loan programs and information regarding default risks and the types of loans being consolidated, is important to the estimation process.

As reflected in footnotes to the President's Budget for FY 2003, the Administration is in the process of developing revisions to the method of calculating cost estimates for the Department's guaranteed and direct loan programs. As late as January 2002, there were discussions regarding whether a revised process could be developed and potentially significant re-estimates reflected in the FY 2001 financial statements, and how OMB views regarding the Department's and SFA's credit reform calculation were to be addressed, including issues related to appropriate interest rate assumptions and preparation of estimates for each type of loan by cohort year. These discussions drew to a close when the President's Budget was finalized in February 2002. As the Department and SFA seek to comply with OMB directives to prepare and release audited financial statements earlier (November 2004 for FY 2004), the timing of conclusive consultations between OMB and the Department in future years should be addressed. A concerted approach drawing on FASAB, OMB budgetary and management personnel, and the audit community may be needed to address this issue, which in critical respects transcends Department and SFA issues. If these issues are not addressed, the risk increases that amounts reported in the financial statements may not be materially consistent with amounts reported in the President's Budget, and that sufficient procedures may not exist to timely address and account for potential re-estimates or methodology changes in the financial statements.

Recommendation:

We recommend that SFA perform the following:

1. Coordinate with the Department to perform a detailed analysis and review of the activity that flows through the general ledger accounts specific to the loans and cash flows for subsidy costs and related allowance and loan liability estimates for the FFEL programs. In addition, regular analytical reviews should be performed of all the critical elements of the affected accounts. Such analysis should be performed on a quarterly basis and should include a reconciliation between the general ledger credit reform accounts (e.g., 1399 or 2180) and the data submitted by the guaranty agencies and Department's subsidiary systems.

2. Coordinate with the Department to enhance the current formal written policies and procedures to include documentation of roles and responsibilities of each organization, OCFO, SFA and Budget Service, involved with the financial reporting process of the subsidy costs and the related loan liability and allowance estimates.

3. Coordinate with the Department to gather data in a manner that will enable SFA to better monitor and report on consolidations.

4. The long-term cost of direct loans is estimated based on FFEL cash flow activity. Coordinate with the Department to consider using direct loan cash activity for future projections of direct loan subsidy cost.

5. Emphasize in appropriate external communications regarding the subsidy estimates, including significant financial and budgetary reports and presentations, the sensitivity of the estimates to changes in assumptions.

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

In connection with the annual audit of SFA's fiscal year 2001 financial statements, we conducted a controls review of the information technology (IT) processes related to the significant accounting and financial reporting systems. These systems included: Education Central Automated Processing System (EDCAPS), National Student Loan Data System (NSLDS), Direct Loan Servicing System (DLSS), Federal Family Education Loan System (FFEL) and the Loan Origination Subsystem (LOS). OMB Circular A-130, *Management of Federal Information Resources*, requires: (1) standard documentation and procedures for certification and accreditation of systems; (2) records management programs that provide adequate and proper documentation of agency activities; (3) agencies to develop internal information policies and procedures and oversee, evaluate, and otherwise periodically review agency information resource management activities; and (4) agency plans to assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the system.

During fiscal year 2001, management has made progress in strengthening controls over information technology processes. The implementation of new controls and the reinforcement of existing controls increased the effectiveness of internal controls in areas such as security management and disaster recovery planning. Among others, the Department, which includes systems that support SFA, has implemented logging and monitoring controls for the Windows NT platform that supports EDCAPS, strengthened the system software change management process, and implemented and tested a disaster recovery facility for EDCAPS. However, we find that continuous effort is needed to further address control weaknesses related to information technology and systems. In particular, audit reports prepared by the General Accounting Office (GAO) and the Office of Inspector General (OIG) identify control weaknesses that need to be addressed. These audit reports include:

- Department of Education's Implementation of GISRA, audit control number ED-OIG/A11-B0007 (issued by OIG);
- Disaster Recovery and Backup Plans for Selected Information Technology Systems, audit control number ED-OIG/A11-0009 (issued by OIG); and
- GAO Report: Education Information Security – Improvements Made but Controls Weaknesses Remain, audit control number GAO-01-1067 (issued by GAO).

With respect to overall security management, SFA and the Department need to develop, implement, and maintain an agency-wide risk based information security plan, programs, and practices to provide security throughout the life cycle of all systems. Specifically, related to GAPS, the Department needs to strengthen controls over critical financial and sensitive grant information to prevent unauthorized access and disclosure. The Department has identified numerous security weaknesses, including the lack of an overall IT security program, in its Government Information Security Reform Act (GISRA) report and the "Agency-Wide Plans of Actions and Milestones". The Department also identified its IT Security Program as a material weakness in its FY 2001 Federal Managers' Financial Integrity Act report.

The material weakness previously discussed regarding financial management systems and financial reporting indicates that internal control within SFA and the Department is evolving and requires additional improvement. The lack of compensating manual controls increases the need for strong information technology controls to ensure the integrity and security of SFA's and the Department's data.

Recommendation:

SFA should implement corrective actions outlined in audit reports issued by GAO and OIG.

STATUS OF PRIOR YEAR FINDINGS

In the reports on the results of the fiscal year 2000 audit of the Student Financial Assistance financial statements, a number of issues were raised relating to internal control. The chart below summarizes the current status of the prior year items:

Figure 1: Summary of FY 2000 Material Weaknesses and Reportable Conditions

Issue Area	Summary Control Issues	FY 2001 Status
Financial Management Systems and Financial Reporting Need to Be Strengthened (Material Weakness)	Significant weaknesses in SFA's financial reporting processes existed as a result of the EDCAPS general ledger software package, Financial Management System Software (FMSS).	Improvements Noted – Modified Repeat Condition Material Weakness
Reconciliations Need to Be Improved (Material Weakness)	SFA did not perform proper or timely reconciliations of its financial accounting records.	Improvements Noted - Relevant conditions merged into related comments with Financial Reporting and Credit Reform
Controls Surrounding Information Systems Need Enhancement (Material Weakness)	Improvements are required in security over financial systems and in disaster recovery capabilities.	Improvement Noted- Modified Repeat Condition Reportable Condition
Improvement of Financial Reporting Related to Credit Reform (Reportable Condition)	Management controls need to be strengthened over financial reporting related to credit reform.	Modified Repeat Condition– Reportable Condition

We have reviewed our findings and recommendations with SFA management. Management generally concurs with our findings and recommendations and will provide a corrective action plan to the OIG in accordance with applicable Department directives.

In addition to the reportable conditions described above, we noted certain other matters involving internal control and its operations that were reported to management in a separate letter dated February 4, 2002.

This report is intended solely for the information and use of the management of SFA and the Department, OMB, Congress and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

February 4, 2002
Washington, D.C.

Section III

Report on Compliance with Laws and Regulations

ERNST & YOUNG LLP
1225 Connecticut Avenue, N.W.
Washington, D.C. 20036
Phone: 202 327 6000

Report on Compliance with Laws and Regulations

To the Inspector General
U.S. Department of Education

We have audited the consolidated balance sheets of the Student Financial Assistance (SFA), a performance-based organization of the U.S. Department of Education (the Department), as of September 30, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing for the fiscal years then ended, and have issued our report thereon dated February 4, 2002. That report noted certain matters that resulted in a qualification of our opinion on the consolidated balance sheets, and related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources and financing.

Except for the matters discussed in the third paragraph of the Report of Independent Auditors, we conducted our audits in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of SFA is responsible for complying with laws and regulations applicable to the entity. As part of obtaining reasonable assurance about whether the entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to SFA. We caution that noncompliance may occur and not be detected by the tests performed and that such testing may not be sufficient for other purposes.

The results of our tests of compliance disclosed no instances of noncompliance with other laws and regulations discussed in the previous paragraph exclusive of FFMIA that are required to be reported under Government Auditing Standards or OMB Bulletin No. 01-02.

Under FFMIA, we are required to report whether SFA's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this reporting requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed instances in which the Department's financial management systems did not substantially comply with certain requirements discussed in the preceding paragraph. SFA relies on the Department's systems to provide support for SFA's financial reporting needs, including utilizing the Department's general ledger to process transactions. We have identified the following instances of noncompliance:

- The financial management system of record during FY 2001 impairs the Department's ability to accumulate, analyze, and present reliable financial information. This condition is primarily due to the absence of certain components of a fully integrated financial management system, and includes deficiencies in the general ledger system and manual adjustment process. The accounting system is in the process of being replaced. Certain other financial management controls, such as reconciliation processes, are continuing to evolve. In addition, the Department did not submit certain periodic financial reports on budget execution for the Direct Loan and Federal Family Education Loan Program (FFELP) financing accounts to Treasury as required due to reconciliation problems. We noted that the reports for the period ended September 30, 2001 were submitted.

- The Department has implemented and tested a disaster recovery facility for the Education Central Automated Processing System (EDCAPS). However, audit reports prepared by the General Accounting Office (GAO) and the Office of Inspector General (OIG) identify certain control weaknesses that need to be addressed. With respect to overall security management, the Department needs to develop, implement, and maintain an agency-wide risk based information security plan, programs, and practices to provide security throughout the life cycle of all systems. In addition, the Department needs to strengthen controls in the Grant Administration and Payment System (GAPS) over critical financial and sensitive grant information to prevent unauthorized access and disclosure. The Department also identified its IT Security Program as a material weakness in its FY 2001 Federal Managers' Financial Integrity Act report, citing the need to strengthen information technology systems to comply with the Computer Security Act and OMB Circular A-130, *Management of Federal Information Resources*.

The Report on Internal Control includes information related to the financial management systems and accounting standards that were found not to comply with the requirements of FFMIA. It also provides information on the responsible parties, relevant facts pertaining to the noncompliance with FFMIA, and our recommendations related to the specific issues. We have reviewed our findings and recommendations with management of the Department. Management generally concurs with our findings and recommendations and to the extent findings and recommendations were noted in prior years has provided a proposed action plan to the Office of Inspector General in accordance with applicable Department directives.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of SFA and the Department, OMB, Congress and the Department's OIG, and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

February 4, 2002
Washington, D.C.

Section IV

Management's Response

UNITED STATES DEPARTMENT OF EDUCATION
THE OFFICE OF STUDENT FINANCIAL ASSISTANCE
WASHINGTON, D.C. 20202-______

February 4, 2002

Ernst &Young, LLP
1225 Connecticut Avenue, NW
Washington, DC 20036

This is in response to your request for Student Financial Assistance (SFA) comments on the fiscal year 2001 reports on Internal Controls and Compliance with Laws and Regulations. Thank you for providing SFA the opportunity to review the draft reports mentioned above and for allowing us to provide comments.

We are in general agreement with the recommendations identified in the reports. We will continue our coordination with the Department to assure that the issues raised in the reports are appropriately addressed in comprehensive corrective action plans aimed at determining the best way to achieve the desired results.

While additional improvements are needed to address the weaknesses reported, as your staff noted, SFA has made improvements to its financial reporting processes and financial management activities during fiscal year 2001. The Department and SFA are currently implementing more robust financial management systems.

It is important to note that the widespread existence of these adjustments and the qualified opinion are not indicative of widespread fraud, waste or mismanagement in the SFA programs. Analysis and independent audits of institutions, lenders, guaranty agencies, and third-party servicers have shown that SFA funds are materially spent in accordance with law and regulation.

SFA is committed to continuing efforts to improve financial management and accountability over SFA programs and to better serve students and taxpayers.

Sincerely,

James R. Lynch
Chief Financial Officer
Student Financial Assistance

Section V

Management's Discussion and Analysis

Student Financial Assistance

Management's Discussion and Analysis

This Management's Discussion and Analysis (MD&A) provides an overview of the Student Financial Assistance (SFA) Program. It describes who we are, what we do and how well we meet the goals we have set. It also addresses our financial performance and our management control responsibilities. The following discussion and analysis relates to the operations of the SFA Program as of and for the year ended September 30, 2001.

Mission and Organizational Structure

We Help Put America Through School

SFA's mission is to "help put America through school" by providing access to higher education through effective and efficient delivery of student aid. SFA was created with a mandate to improve customer service, reduce cost, and improve and integrate the student aid processing and delivery systems.[1] During FY 2001, this access was expanded through:

1) Increasing investments in Pell Grants,

2) Delivery of a series of useful and informative publications,

3) A Web-based Free Application for Federal Student Aid (FAFSA) that allows applicants to chat on-line with customer service agents about technical problems or difficulties, and

4) A new PIN signature feature for customers to "sign" their promissory notes on-line.

SFA is organized into channels along customer lines to allow for continual customer feedback and tailoring of services to meet their needs. These channels - student services, school services and financial partner services - operate under the Chief Operating Officer (COO).

The core of SFA's management team consists of General Managers for Students, Schools, and Financial Partners, along with the Chief Information Officer (CIO) and the Chief Financial Officer (CFO). The three general managers run basic program operations and determine what improvements are needed to keep pace with changing expectations.

[1] SFA, formerly the Office of Student Financial Assistance Programs within the Office of Postsecondary Education (OPE), was authorized by the Higher Education Act Amendments of 1998 (HEA) and became the federal government's first-ever Performance-Based Organization (PBO). The goal of the HEA legislation was to improve service and reduce cost. SFA is now a principal operating component within the Department of Education, separate from OPE.

Student Financial Assistance
Management's Discussion and Analysis

The General Manager (GM) for Students is charged with improving student and borrower awareness of financial aid options and ensuring the smooth and efficient processing of student transactions.

The GM for Schools provides assistance to schools to ensure they can meet program eligibility requirements, and oversees ongoing financial and other transactions with schools.

The GM for Financial Partners works with states, lenders and guaranty agencies, providing technical assistance, processing financial transactions, and collaborating on better ways to support the needs of students and schools.

The CIO provides technical support to:

1) GMs in the development of new system applications
2) CFO in implementing an integrated financial management system that will monitor SFA's financial performance
3) Other operating units in designing efficient and effective systems to support operations.

The CFO provides financial management, facilities management, internal reviews, travel management, budget and financial information analyses and reports to all areas of SFA and the Department of Education.

The CFO is responsible for the reconciliation of nearly a dozen financial-related systems to ensure timely and reliable data for internal and external decision-making. The CFO is also responsible for assuring that financial reports are issued to the Department of Education, Treasury, OMB and Congress.

Other SFA business process managers that provide program support include:

- Human Resources Director,
- Acquisitions Director,
- Analysis Director,
- Communications Director,
- SFA University Director, and
- Ombudsman.

In 2001, SFA delivered over $61 billion in Federal aid to more than 8.1 million postsecondary students and their families. Under the Federal Family Education Loan (FFEL) and Direct Loan programs, SFA oversees or directly manages over $231 billion in outstanding loans, representing over 122 million individual student loans. SFA interacts with over 6,000 schools, over 4,000 lenders, 36 guaranty agencies, dozens of accrediting agencies, as well as secondary markets, third party servicers and other organizations, including states.

In accordance with the PBO model, SFA has outlined

- clear objectives,
- specific measurable goals,
- customer service standards, and
- targets for improved performance.

The following paragraphs briefly describe each of the major programs that deliver Federal aid to students and their families.

Student Financial Assistance
Management's Discussion and Analysis

The **Pell Grant** Program helps ensure financial access to postsecondary education by providing grant aid to low- and middle-income undergraduate students. The most need-focused of the Department's student aid programs, Pell Grant awards, vary in proportion to the financial circumstances of students and their families. During FY 2001, almost 4 million students received grants averaging $2,311.

Two major student loan programs account for most of the remainder of the Department's support for postsecondary education. The **Federal Direct Loan Program** lends funds directly to college students. The U.S. Treasury provides loan funds for the Direct Loan Program. Funds for the **Federal Family Education Loan (FFEL) Program** are provided by private lenders and are insured by guaranty agencies and reinsured by the federal government.

The Direct Loan Program offers borrowers a variety of repayment options including standard repayment, graduated repayment, extended repayment and income contingent repayment. Under legislative amendments enacted in Fall 1998, lenders participating in the FFEL Program now offer all the repayment options available in Direct Loans except for extended repayment.

The Department's **Campus-Based** programs provide funds to institutions which enables them to provide employment, grants, and low interest loans on the basis of student needs.

Performance Goals and Results

SFA is all about performance. We set performance goals, we measure our performance and we are rewarded according to our performance. SFA's operations are shaped by a Five-Year Performance Plan with multi-year goals stated in terms of specific, quantifiable improvements in three areas:

- Improving customer satisfaction,
- Reducing unit cost, and
- Improving employee satisfaction.

To help us reach our multi-year goals, we set annual operating objectives and established improvement projects. Several of these objectives and improvement projects also define and evaluate SFA's approach to improving and integrating the student aid processing and delivery systems.

Customer Satisfaction: We let our customers judge our performance. We used the American Customer Satisfaction Index (ACSI), an annual survey done by the University of Michigan. In FY 1999, we set our long-term goal to equal the private sector score of 74.4 by FY 2002. We scored just below our FY 2002 goal. In FY 2001, we achieved an overall score of 74.2, just two-tenths of a point below the average for the private sector.

Unit Cost: The SFA unit cost which is calculated by dividing SFA obligations by the number of aid recipients, was reduced from $20.14 in 2000 to $19.57 in 2001, about 3 percent. This reduction is consistent with the SFA plan to reach the multi-year goal of a 19 percent overall reduction in unit cost.

In calculating the obligation unit cost for fiscal year 2001, SFA focused on controlling those funds that supported its operations, i.e., funds for salaries and benefits, for operations and modernization contracts, and for general operations such as travel, training, equipment, printing, etc. This focus fulfills our commitment to manage spending in those areas that SFA fully controls. The $615 million actual budget cited above includes fiscal year 2001 operations funds provided by the Congress that were allocated by the Secretary to SFA for administration of the SFA programs.

The table below provides detail on SFA's obligation unit costs between 2000 and 2001:

Target Unit Cost Trends based on Obligations
(In millions)

Unduplicated Recipients	*29.548*		*31.398*	
	2000		**2001**	
	Actual Budget		**Without $15 mil PY Funds**	
	Obligations	**Unit $**	**Level Budget**	**Unit $**
Labor	$ 92		$ 101	
Contracts	$ 456		$ 477	
Other	$ 47		$ 37	
Subtotal	$ 595	$ 20.14	$ 615	$ 19.57

Employee Satisfaction: SFA's goal, by the year 2004, is to earn an overall score of 3.6 in the area of employee satisfaction. According to the March 2001 results of the Gallup's measuring system, SFA employee satisfaction stood at 3.74 – higher than the average scores of government agencies (3.4) and private financial businesses (3.6).

In FY 2001, SFA established 86 objectives and improvement projects along with indicators to measure our success. A specific channel, office or enterprise owns each objective or project, but they support each other. The accomplishment of any one of these projects discloses the extent to which each channel has achieved its intended objectives. We have selected a few of these projects to show how we measured up to our multi-year goals.

Students Channel

The Students Channel has three business processes that serve students most directly – aid awareness, aid application, and loan repayment.

Aid Awareness: This encompasses outreach activities -- operating our call center, and publications such as *The Student Guide.*

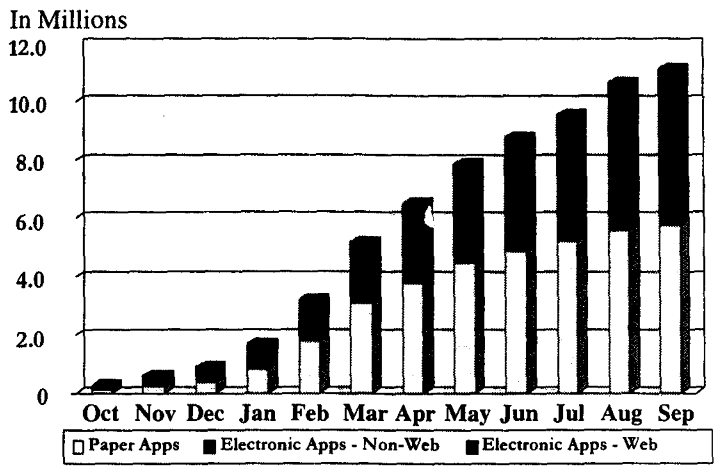
Customer Satisfaction – SFA set and achieved its goal -- to answer more than 95% of all calls for our toll-free line, 1-800-4-FED-AID. Of the calls placed to the toll-free number during FY 2001, 98% were answered. SFA achieved a satisfaction index score of 85.4 on the FY 2001 ACSI survey.

Customer Satisfaction – SFA accomplished its FY 2001 goal – to create and launch new products/services/delivery approach to increase the amount of student aid related information available to students and parents. SFA published 2001-2002 Spanish versions of the *Student Guide, and Funding Your Education* and *FAFSA;* a brochure on finding free information on scholarships and applying for federal student aid; and a federal student aid poster that raises awareness about student aid scams.

Aid Application: This includes the acceptance and processing of Free Applications for Federal Student Aid (FAFSAs). Some of the projects completed this year improved service for applicants and reduced the cost of processing applications.

Customer Satisfaction – SFA increased the number of FAFSAs filed electronically from four million last year to over five million in FY 2001. The electronic application is faster and easier for the students to file and for the Department to process. Of 11.1 million applications processed in FY 2001, 5.36 million were filed electronically. For its Web-based FAFSA, SFA was the recipient of the 2001 E-Gov Explorer Award. The FY 2001 ACSI score for FAFSA on the Web was 82.4.

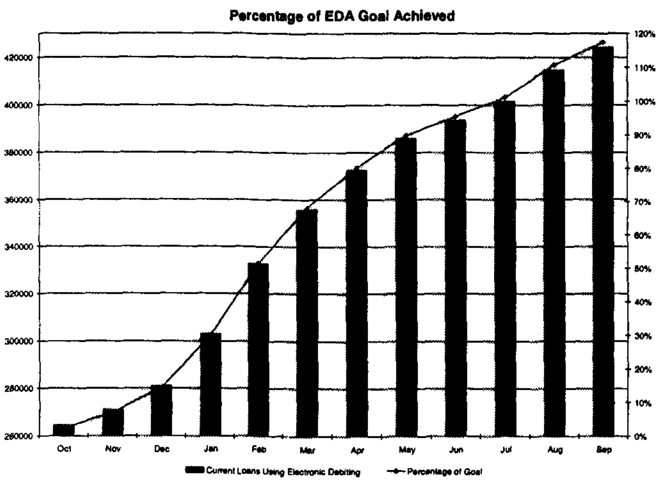
FAFSAs Processed in Fiscal Year 2001



Student Financial Assistance
Management's Discussion and Analysis

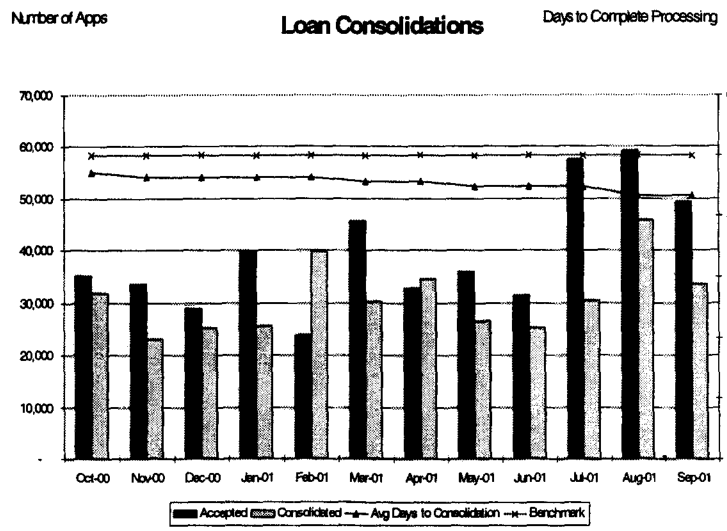
Loan Repayment: This encompasses billing and servicing our borrowers who are repaying one or more Direct Student Loans, and processing applications for borrowers who wish to consolidate previous student loans into one Direct Loan account.

Customer Satisfaction – SFA increased the total number of borrowers repaying their Direct Loans through Electronic Debiting from 261,000 at the beginning of FY 2001 to nearly 425,000 at the end of the fiscal year.

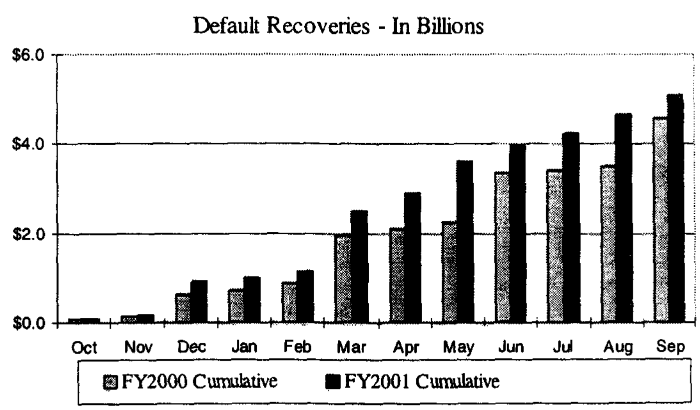


Reduce Costs -- SFA implemented the National Directory of New Hires (NDNH) database matching program—collecting over $150 million as a result of matching SFA collection records with this Health and Human Services (HHS) database. Since matching efforts with HHS starting January 2001, new information has been obtained on over 890,000 accounts, with unpaid loan balances totaling $3.2 billion.

Customer Satisfaction – SFA processes 20,000 to 40,000 applications for Direct Loan Consolidations each month with year-to-date turnaround time averaging 42 days (through September 30, 2001), exceeding the goal of 50 days or less for FY 2001.



Reduce Cost -- SFA exceeded its goal of keeping the default recovery rate at 10% or higher. For FY 2001, funds collected resulted in annual recoveries of 17.7% of the outstanding portfolio. The combined ED and Guaranty Agency (GA) collections on defaulted loans totaled $5.121 billion for FY 2001.



Student Financial Assistance

Management's Discussion and Analysis

Schools Channel

During FY 2001, the Department of Education worked with over 6,000 postsecondary institutions to deliver grant, loan, and work-study assistance to students who rely on federal student aid to pay for college.

SFA has four business processes that serve schools – loan origination and disbursement, program eligibility, program support, and financial transactions.

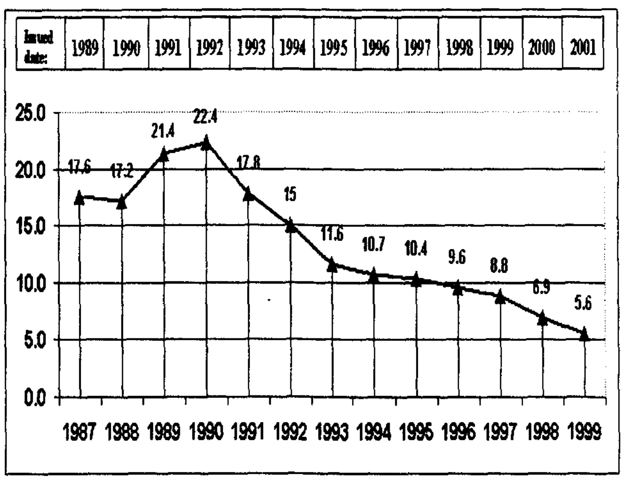
Origination and Disbursement: This encompasses the origination and disbursement of all Title IV aid. The 2000 ACSI score of 79 is good, but customers say there is plenty of room for improvement.

Customer Satisfaction – During FY 2001, SFA designed a Common Origination and Disbursement (COD) process. COD is a new streamlined method for processing Direct Loan, Pell, and Campus-Based data. The COD System will integrate the origination and disbursement processes of the current Recipient Financial Management System (RFMS) and the Loan Origination System (LOS) for the Direct Loan Program into one system, and also accept student level data for the Campus-Based programs. Implementation is planned for the 2002-2003 award year.

Program Eligibility: Through initial certification and periodic recertification, SFA makes sure that participating schools are managing public funds properly and serving students well. Therefore, the process needs to be thorough, but it should also be as simple and understandable as SFA can make it for schools.

Reduce Cost — SFA cut the cohort default rate[2] by 75 percent from 22.4 percent in FY 1990, to its lowest point ever, 5.6 percent in FY 1999 (the most recent cohort default rate data available). Congress and the Department have taken actions to reduce defaults—including management reforms and increased attention to assist at-risk postsecondary institutions.

COHORT DEFAULT RATES FOR FY1987-1999



[2] The "cohort default rate" is a key measure of student loan defaults. It is defined as the percentage of borrowers who entered into repayment on FFEL and Direct Loan Program loans during one fiscal year and defaulted on those loans in the same fiscal year they entered repayment or the next fiscal year.

Program Support: This covers the broad range of work done by SFA's direct loan account managers, case management teams, and the technical support center, to help schools succeed in their environment.

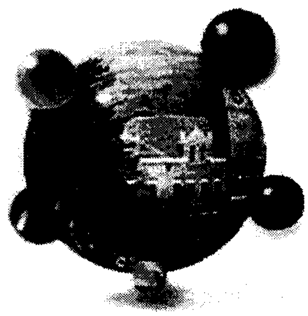
SFA made some real strides this year tailoring products and services to fit differing sizes and kinds of schools. SFA's e-commerce strategy with user-friendly Web-based applications will eliminate many sources of confusion and questions. Schools will have a single point of contact to call -- someone who will work on their behalf to get any question answered, any problem solved.

Customer Satisfaction – In March 2001, SFA released Version 1 of a new Web-based School Portal, *http://sfa4schools.sfa.ed.gov*. For the first time, many SFA school services and information are consolidated through a master Web page with everything the school needs and can be customized to meet the needs of each user.

Financial Transactions: These are the processes schools use to get the money for Direct Loans, Pell Grants and Campus-Based aid programs.

Customer Satisfaction/Reduce Costs -- In September 2001, SFA launched the FISAP on the Web—another step forward in the modernization of student aid delivery. The Fiscal Operations Report and Application to Participate (FISAP) is the application schools fill out to apply for Campus-Based aid for the year ahead and to report their aid allocation for the previous year. With FISAP on the Web, schools now have the ability to make corrections immediately and process changes in real-time, resulting in lower operating costs for SFA.

Overall, an encouraging 80% of school administrators report that they have seen improvement in SFA this year. SFA is obviously on the right track. SFA's e-commerce strategy, with modern technology and Web applications, is the key to further improvement in customer satisfaction as well as reduced cost.



Financial Partners Channel

During FY 2001, the Department of Education worked with over 4,000 lenders, and 36 guaranty agencies to deliver guaranteed loan assistance to students who rely on federal student loans to pay for college.

SFA has three business processes that serve our financial partners who participate in the FFEL Program – program eligibility, program support, and financial transactions.

Program Eligibility: This serves a similar purpose as school program eligibility — to make sure that participating financial institutions are managing public funds properly and serving students well. Therefore, the process needs to be thorough, but simple and understandable.

Reduce Cost – In September 2001, in connection with the National Student Loan Program, SFA implemented a centralized processing Pilot Project to address potential fraud in the forgiveness of student loan debt through death and disability discharges. The Pilot Project procedures provide for consistent review of applications and critical post submission analysis to identify fraudulent claims.

Program Support: This provides technical support to participating financial institutions.

Customer Satisfaction /Reduce Cost – SFA launched four performance-based Voluntary Flexible Agreements to pilot innovative ways to improve student aid administration, such as rewarding guaranty agencies for resolving and preventing defaults

Financial Transactions: The area related to financial transactions was the area that our financial partners told us was most important to them.

Customer Satisfaction – In July, at the E-Gov 2001 Conference, the SFA FORMS 2000 project was recognized as an E-Gov 2001 Pioneer Award winner, the highest award given by *E-Gov Journal.* FORMS 2000 is a Web-based guaranty agency reporting system for submitting applications for reimbursement. This electronic form replaced three reports. SFA anticipates that this system will save the FFEL community substantial time and money, reduce error rates and speed up payment processing.

Customer Satisfaction -- In May 2001, the first release of Financial Partner's Data Mart was unveiled. The data mart will provide access to historical information from the FFEL system. Subsequent releases will provide for links with other systems, expand the amount of data that can be accessed and will allow guaranty agencies and other SFA organizations access to FFEL financial information needed for reviews, technical assistance and analysis.

SFA Financial Analysis

The preparation and audit of financial statements are significant functions demonstrating the strength of the financial information, financial systems, and internal controls maintained by SFA.

For FY 2001 and FY 2000, SFA prepared the Balance Sheet, Statement of Net Cost, and Statement of Changes in Net Position on a consolidated basis. The Statement of Budgetary Resources and the Statement of Financing were prepared on a combined basis. An Independent Auditor appointed by the Office of the Inspector General audited these statements, and the Opinions on these statements are included in this Report.

SFA has substantial assets currently under its management. Of the $100.4 billion in assets held by SFA as of September 30, 2001, $80.3 billion consist of Net Credit Program Receivables held by the Direct Loan (DL) program and the Federal Family Education Loan (FFEL) program, and $17.2 billion consists of Fund Balance with Treasury. DL holds $74.7 billion or 93% of Net Credit Program Receivables while FFEL holds $5.6 billion or 7%. (The FFEL portfolio consists of FFEL-defaulted loans that the Department owns itself.) The Net Credit Program Receivables are valued using present value methodology and the allowance for subsidy for the DL loan receivables is a negative $1.6 billion indicating recoveries greater than outlays. The FFEL allowance is ($16.9) billion as of September 30, 2001 indicating outlays greater than recoveries. The significant asset of the Pell Grant Program is its Fund Balance with the Treasury, which are unexpended appropriations, the majority of which have been obligated for disbursement to eligible students.

SFA's liabilities of $93.8 billion as of September 30, 2001 consist mainly of $77.2 billion in the Direct Loan Program borrowed from the Treasury to fund its loan program. The FFEL Program has $8.4 billion in estimated loss for projected future defaults on loans in which it is the guarantor. In addition to these amounts, FFEL has $2.5 billion Payable to Treasury for amounts due from guaranty agencies, representing the amount in the Federal Funds held by guaranty agencies. These amounts, if collected, are immediately payable to Treasury.

SFA's net position is $6.6 billion, consisting of FFEL, DL, and Pell Grant Program unexpended appropriations.

SFA's net cost of operations for the year ending September 30, 2001 was $12.7 billion. In the Direct Loan Program, net cost of operations was $1.7 billion and was comprised of a $1.3 billion subsidy expense. In the Pell Grant Program, grant expense was approximately 99% of its net cost of operations. In the FFEL Program, net cost of operations was $69.2 million and was comprised of negative $314 million in subsidy expense with the remainder from other types of administrative and contractual service expenses. In addition, indirect costs incurred by the Department of Education are allocated to each SFA program for financial reporting purposes.

Appropriations are made at the beginning of each fiscal year to cover the estimated losses on loans to be made or guaranteed during that year, and for the Pell Grant Program. Permanent indefinite appropriation authority is available to finance operations resulting from loan guarantees in years before FY 1992. For the FFEL and Direct Loan Programs, an amount to cover the subsidy cost of each program as well as an amount to cover administrative expenses is appropriated. The Pell Grant Program receives one appropriation that covers actual grant disbursements and the administrative costs of managing the program.

The FFEL and Direct Loan Programs have authority to borrow from Treasury at interest rates determined by Treasury each year. These programs repay Treasury over time using principal and interest collected from borrowers. The Direct Loan Program may borrow from Treasury to finance direct loans and for downward revaluation of subsidy cost. The FFEL Program may borrow from Treasury to finance guaranteed loan obligations and for downward adjustments of subsidy cost. Borrowings may be repaid before maturity without penalty.

Systems, Controls and Legal Compliance

External audits by the General Accounting Office (GAO) and independent accounting firms, internal audits by the Office of Inspector General (OIG) and reviews by SFA program offices evaluate the adequacy and efficiency of SFA's and its Partner's operations and systems to provide overall assurance that their business processes are functioning as intended. The reviews also ensure that management controls and financial management systems comply with the standards established by the Federal Managers' Financial Integrity Act (FMFIA), Federal Financial Management and Improvement Act, Paperwork Reduction Act, Computer Security Act and Office of Management and Budget (OMB) Circulars A-123, A-127 and A-130 and A-133.

Prior audits, reviews, studies and observations of daily operations have identified management control and financial integrity issues and weaknesses. Findings contained in numerous audits and program reviews have questioned the integrity of data recorded in the Department and SFA systems that play an integral part in SFA's accountability over student aid funds. For the past four years, auditors contracted by the OIG have reported as a material weakness that "Financial Management Systems and Financial Reporting Needs to Be Strengthened". GAO has continued to include the student aid program on its High Risk List. Although the Department and SFA made progress during FY 2000, the financial statement audit report disclosed that:

> ***"significant financial management issues continue to impair SFA's ability to accumulate, analyze, and present reliable financial information. These weaknesses are primarily due to the absence of certain components of a fully integrated financial management system."***

As a result, SFA failed to get a clean audit in FY 2000.

Long-standing management and financial control issues prompted PBO legislators to require SFA to implement an integrated system for delivering student aid that contains complete, accurate, and timely data to ensure program integrity.

Initiatives to Improve Delivery of Aid

E-commerce is SFA's main cost-cutting strategy for reducing the cost of delivery of financial aid to each student. This strategy cuts our costs by making our business processes faster, less error-prone and less labor intensive. And, at the same time, greatly improves the quality of service to our customers. So, we have executed a multi-year plan to invest in modern, integrated technology and phase-out our inefficient, stand-alone systems. SFA is also leveraging the Internet, cutting-edge technologies and middleware.

The SFA **Modernization Blueprint** at the Web address http://sfablueprint.gov/, provides the information technology architecture—an Integrated Sequencing Plan that contains the details of our modernization projects and initiatives—for SFA's approach to aid delivery. The Blueprint highlights the projects SFA has undertaken or will undertake that deliver the most visible and direct impact for students, schools, and financial partners. The goal is to transform SFA systems, to make SFA processes Web-enabled, and our systems integrated and consolidated. This simplified business and technical model will allow students, schools, and financial partners to access the information they need, when they need it, on paper, by telephone, and over the Internet.

As discussed in the goals and results section of this report, SFA has implemented a series of new technologies to move to this new, more modernized environment. During FY 2001, SFA improved its core business processes in the delivery of aid. SFA –

- Is processing aid applications faster and more accurately, consolidating loans faster and helping more borrowers avoid defaults.
- Has implemented new processes to hold default rates to all-time lows.
- Is ensuring that death and disability claims are scrutinized for accuracy.

In addition, we have implemented procedures and are enforcing our policies that safeguard government property and that ensure student and parent grant and loan applicants obtain aid based on accurately reported income. Whenever possible, SFA is achieving cost and saving time by implementing existing platforms and using Commercial Off-the-Shelf (COTS) products.

Initiatives to Improve Financial Integrity and Accountability

The development and implementation of a fully integrated Financial Management System (FMS) became SFA's strategy for managing its financial operations and improving accountability over its resources.

In FY 2001, the CFO's financial management goals were aimed at reducing cost and promoting financial integrity in Department and SFA programs.

FMS

GOAL

Provide full accounting capability for all SFA programs through implementation of the Financial Management System using Oracle Federal Financial Products.

Reduce Cost -- In FY 2001, SFA developed, tested and deployed Phase III of the Oracle Federal Financial Management System (SFA FMS). Beginning October 2001, SFA FMS began to support full program functionality, which will allow us to prepare useful management and information reports (e.g. cost management and program funds, etc.) SFA also gained the ability to prepare more timely management information reports and access the data it needs to assist in and perform reconciliations. Now, all SFA financial transactions are completed through FMS. Finally, SFA has a fully functioning subsidiary ledger, which provides SFA and the Department with better support and audit trails for SFA and the Department's independent auditors.

Activity-Based Costing

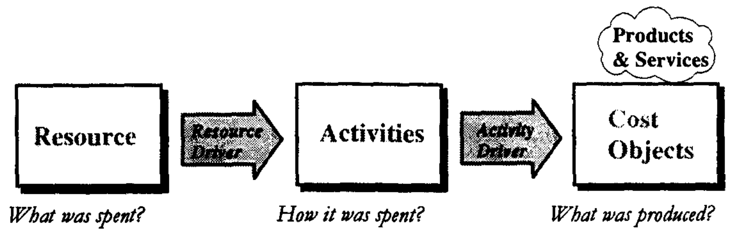
GOAL
Enhance the SFA-wide activity – based costing module with our FMS and CFO data mart to track unit costs and provide quarterly managerial reports on core business processes.

Reduce Cost – In FY 2001, SFA enhanced the Activity-Based Cost (ABC) Model to include costs for Channel and Enterprise offices. The Cost Team developed a user-friendly reporting tool (MS Pivot Tables) for providing managers with on-line multidimensional views of the ABC results. SFA will be presenting its FY 2003 proposed budget in an ABC format.

ABC is a methodology that assigns costs to activities based on the utilization of resources and assigns costs to cost objects based on their consumption of activities. ABC is a management tool that:

- Provides insight into the relationships between Inputs (Resources – What was Spent) and Outputs (Products & Services) by qualifying the work performed (Activities).
- Identifies the cause-and-effect relationship that better assigns cost of products and services by identifying the activities used in the production and delivery of the outputs.

The ABC system tracks the organization's unit cost and provides quarterly management reports on business processes.



Improved Financial Management

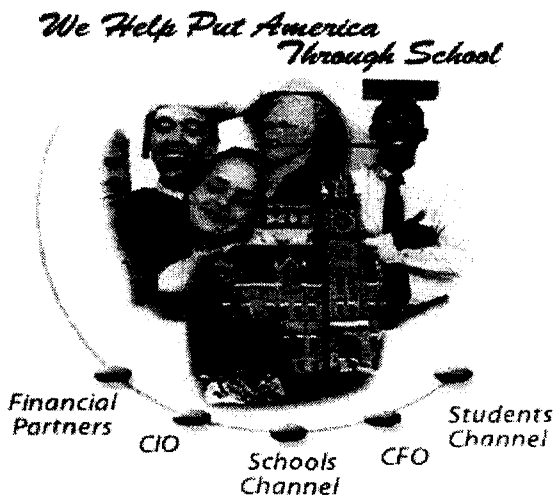
GOAL
Demonstrate enhanced SFA financial management through new IT systems, improved processes, more experienced professional staff, stronger internal controls, and robust financial reports.

Reduce Cost – SFA improved payment controls for credit cards by establishing new internal procedures and by developing a purchasing handbook.

Reduce Cost – SFA improved asset management controls by implementing policies and procedures to prevent fraud, theft and waste and to reconcile discrepancies in SFA's asset inventory.

Reduce Cost – SFA reconciled years of unmatched accounting transactions and prepared written procedures and operating policies to prevent a reoccurrence of past mistakes.

Reduce Cost – From April through September 2001, SFA implemented 208 of 303 outstanding OIG and other audit/management recommendations.



"Enabled by technology, these are the things that will align us all to do an even better job at helping put America through school—helping make dreams come true."

GREG WOODS, Chief Operating Officer, Student Financial Assistance. Remarks to House Appropriations Hearings Committee, March 15, 2000.

Limitations of the Financial Statements

The financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

Section VI

Fiscal Year 2001 Financial Statements and Notes

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidated Balance Sheet
As of September 30, 2001 And September 30, 2000
(Dollars in Thousands)

	2001	2000
Assets		
Intragovernmental Assets:		
Fund Balance with Treasury (Note 2)	$17,196,330	$22,758,091
Accounts Receivable, Net (Note 3)	4,488	
Interest Receivable		70,755
Governmental Assets:		
Accounts Receivable, Net (Note 3)	111,469	10,351
Credit Program Receivables, Net (Note 4)	80,315,862	70,066,746
Advances	38,738	38,739
Cash and Other Monetary Assets		1,302
Property and Equipment	17,307	
Other Governmental Assets	258,006	236,363
Guaranty Agency Federal & Restricted Funds Receivable (Note 3)	2,462,445	2,231,814
Total Assets	$100,404,645	$95,414,161
Liabilities		
Intragovernmental Liabilities:		
Accounts Payable	$3,410	$1,623
Interest Payable		70,755
Borrowing from Treasury (Note 5)	77,189,105	65,346,881
Guaranty Agency Federal & Restricted Funds Due To Treasury (Note 3)	2,462,445	2,231,814
Payable to Treasury (Note 6)	4,212,555	7,860,621
Other Intragovernmental Liabilities (Note 7)	980	237,686
Governmental Liabilities:		
Accounts Payable	516,097	168,103
Accrued Grant Liability (Note 8)	899,180	319,376
Liabilities for Loan Guarantees (Note 4)	8,376,767	9,978,668
Other Governmental Liabilities (Note 7)	119,937	155,101
Total Liabilities	$93,780,476	$86,370,628
Net Position		
Unexpended Appropriations (Note 9)	$8,738,794	$9,253,010
Cumulative Results of Operations (Note 9)	(2,114,625)	(209,477)
Total Net Position	$6,624,169	$9,043,533
Total Liabilities and Net Position	$100,404,645	$95,414,161

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidated Statement of Net Cost
For the Years Ended September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Program Costs		
Intragovernmental		
Interest Expense, Federal (Note 10)	$5,561,878	$4,972,380
Other Production Expense		150
Contractual Service Expense	12,869	5,015
Salaries and Administrative Expense	95,518	66,181
Bad Debt & Write-offs		235
Governmental		
Subsidy Expense (Note 4)	992,696	(3,637,397)
Grant Expense	10,812,779	8,960,280
Interest Expense, Non-Federal (Note 10)	358	224
Contractual Service Expense	484,012	452,277
Salaries and Administrative Expense	153,427	207,685
Other Program Expenses	194,805	180,163
Total Program Cost	$18,308,342	$11,207,193
Less: Earned Revenues		
Interest, Federal (Note 10)	$1,522,188	$1,761,124
Interest, Non-Federal (Note 10)	4,039,690	3,211,256
Earned Revenues	$5,561,878	$4,972,380
Net Cost of Operations	$12,746,464	$6,234,813

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidated Statement of Changes in Net Position
For the Years Ended September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Net Cost of Operations	$(12,746,464)	$(6,234,813)
Financing Sources (Other than Exchange Revenues):		
Appropriations Used	$13,466,364	$10,673,739
Imputed Financing (Note 12)	129,421	117,570
Future Transfers Out due to Downward Subsidy Re-estimate	(2,706,125)	(4,010,604)
Total Financing Sources	$10,889,660	$6,780,705
Net Results of Operations	$(1,856,804)	$545,892
Prior Period Adjustments (Note 13)	(48,343)	(931,055)
Net Change in Cumulative Results of Operations	$(1,905,147)	$(385,163)
Increase (Decrease) in Unexpended Appropriations	(514,217)	476,516
Change in Net Position	$(2,419,364)	$91,353
Net Position - Beginning of Period	9,043,533	8,952,180
Net Position - End of Period	$6,624,169	$9,043,533

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Combined Statement of Budgetary Resources
For the Years Ended September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Budgetary Resources		
Budget Authority	$37,514,043	$34,511,961
Unobligated Balance-Beginning of Period (Adjusted) (Note 14)	9,879,072	13,203,045
Spending Authority from Offsetting Collections (Adjusted)	27,505,541	21,187,709
Adjustments	(13,407,710)	(10,938,820)
Total Budgetary Resources (Note 15)	$61,490,946	$57,963,895
Status of Budgetary Resources		
Obligations Incurred (Adjusted) (Note14)	$54,749,795	$48,114,812
Unobligated Balances-Available	1,293,179	1,491,844
Unobligated Balances-Not Available	5,447,972	8,357,239
Total Status of Budgetary Resources (Note 15)	$61,490,946	$57,963,895
Outlays		
Obligations Incurred (Adjusted) (Note 14)	$54,749,795	$48,114,812
Less: Spending Authority from Offsetting Collections (Adjusted)	(33,697,223)	(21,364,303)
Obligated Balance, Net-Beginning of Period (Adjusted) (Note 14)	17,466,300	13,664,563
Less: Obligated Balance, Net-End of Period (Adjusted)	(13,985,723)	(17,618,544)
Total Outlays (Note 15)	$24,533,149	$22,796,528

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Combined Statement of Financing
For the Years Ended September 30, 2001 and 2000
(Dollars in Thousands)

	2001	2000
Obligations and Nonbudgetary Resources		
Obligations Incurred (Adjusted) (Note 14)	$54,749,795	$48,114,812
Spending Authority from Offsetting Collections and Adjustments (Adjusted)	(33,697,223)	(21,364,303)
Financing Imputed for Cost Subsidies	129,421	117,570
Financing Sources Transferred Out	(2,706,125)	(4,010,604)
Exchange Revenue Not In the Entity's Budget	4,824,026	4,352,527
Other		
Total Obligations and Nonbudgetary Resources	$23,299,894	$27,210,002
Resources That Do Not Fund Net Cost of Operations		
Change in Amount of Goods, Services, and Benefits Ordered But Not Yet Provided (Net Increases) Net Decreases	$3,095,274	$(2,390,955)
Credit Program Collections that Increase Liabilities for Loan Guarantees or Allowance for Subsidy	11,436,845	8,951,690
Resources that Fund Expenses Recognized in Prior Periods	(4,311)	(4,104)
Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	(35,171,087)	(31,322,996)
Other Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	4,197,500	4,287,223
Total Resources That Do Not Fund Net Cost of Operations	$(16,445,779)	$(20,479,142)
Costs That Do Not Require Resources		
Adjustments	$11,503	$(80,868)
Total Costs That Do Not Require Resources	$11,503	$(80,868)
Financing Sources Yet to be Provided	$5,880,846	$(415,179)
Net Cost of Operations (Note 16)	$12,746,464	$6,234,813

The accompanying notes are an integral part of these financial statements.

Student Financial Assistance

Notes to Financial Statements

September 30, 2001 and 2000

Note 1 - Summary of Significant Accounting Policies

Description of Entity

Student Financial Assistance (SFA) was created as a Performance Based Organization (PBO) within the Department of Education (the Department) under the Higher Education Act of 1965 (HEA) amendments enacted in 1998. SFA is following the mandates of a PBO by developing a management structure driven by strong incentives to manage for results. One of SFA's goals is to help overcome the financial barriers that make it difficult for lower- and middle-income students to attend and complete postsecondary education. SFA administers its appropriations for Title IV Student Financial Assistance Programs to accomplish this goal.

SFA's three major programs are as follows:

The **Federal Direct Student Loan Program**, authorized by the Student Loan Reform Act of 1993, makes loans directly to eligible undergraduate and graduate students and their parents through participating schools. SFA borrows money from Treasury to fund the loans. The program provides interest subsidies for eligible borrowers.

The **Federal Family Education Loan (FFEL) Program**, authorized by the Higher Education Act of 1965, as amended, operates with guaranty agencies to provide loan guarantees on loans made by private lenders to eligible students. The program provides interest subsidies to lenders for eligible borrowers.

The **Grant Programs** that consist of **Pell Grant** and **Campus-Based Programs** provide aid that is not repaid to the Federal Government. The Pell Grant Program provides grant aid to low- and middle-income undergraduate students. Awards vary in proportion to the financial circumstances of students and their families. The Campus–Based Programs provide educational grants and other financial assistance to eligible applicants. These include the Supplemental Educational Opportunity Grant, Work-Study, and Perkins Loan programs. Campus-Based programs are not material to these statements and therefore are reported under Grants.

Basis of Accounting

The financial statements are presented in conformity with accounting principles generally accepted in the United States and follow the guidance provided by the Office of Management and Budget's Bulletin No. 97-01, *Form and Content of Agency Financial Statements* as amended and OMB Bulletin No. 01-09.

SFA's accounting structure reflects both accrual and budgetary accounting transactions. Under accrual accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash. Under budgetary accounting, budgetary resources are obligated based on legal requirements, which may differ from when accrual-based transactions are recorded.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make assumptions and estimates that directly affect the amounts reported in the financial statements, actual results may differ from those estimates.

Estimates for the credit program receivables and liabilities contain assumptions that significantly impact the financial statements. The primary components of this assumption set include, but are not limited to, collections, repayments, default rates, prevailing interest rates, and loan volume. Actual loan volume, interest rates, cash flows and other critical components used in the estimation process may differ significantly from the assumptions made at the time the financial statements were prepared. Minor adjustments to any of these assumption components can create significant changes in the estimate.

SFA and the Department recognize the sensitivity of the changes in assumptions and the impact that the projections can have on the estimate. As a result, management has attempted to mitigate these fluctuations by utilizing historical trend analysis to project future cash flows. The assumptions used for the September 30, 2001 and 2000 financial statements are based on the best information available at the time the estimate was derived.

SFA, the Department and OMB have established a Student Loan Credit Modeling Working Group that will refine the underlying assumptions used to generate baseline and policy estimates. The Working Group plans to summarize the key issues regarding the subsidy calculation methodology ,which requires an OMB policy decision. This is expected to occur in time for the Mid-Session review of the FY2003 Budget.

At this time, the Working Group has not determined a specific set of alternative assumptions or model structures. The use of an alternative set of assumptions or model configurations is considered a change in estimate and may produce cost estimates significantly different than those reflected in these financial statements.

Principles of Consolidation

The Balance Sheet, Statement of Net Cost, and the Statement of Changes in Net Position were prepared on a consolidated basis. The Statement of Budgetary Resources and the Statement of Financing were prepared on a combined basis. Inter-program transactions and balances are required to be eliminated for SFA's three designated programs under the consolidated basis but not under the combined basis.

Present Value Credit Program Receivables and Loan Guarantee Liabilities

The financial statements at September 30, 2001 and 2000 reflect the Department's estimates of the long-term cost of direct and guaranteed loans in accordance with the Federal Credit Reform Act of 1990 (the Act).

The Act requires that the net present value of the estimated long-term cost to the government of new direct loans and loan guarantees be financed from new budget authority and be recorded as budget outlays at the time the direct loans are disbursed. The FASAB's Statement of Federal Financial Accounting Standard No. 2, Accounting for Direct Loans and Loan Guarantees, and Statement No. 18, Amendments to Accounting Standards for Direct Loans and Loan Guarantees and related regulations and guidance, define subsidy costs as the present value of interest subsidies, defaults, fee offsets, and other cash flows, associated with direct loans and loan guarantees in the year loans are disbursed. SFA records subsidy costs as an allowance to direct loans receivables or as liability for loan guarantees.

Subsidy costs are estimated based on the difference between the present values of expected government cash outflows (e.g. interest the government pays to borrow, interest subsidies, and defaults) and inflows (e.g. interest income from borrowers, collections of fees), discounted by the interest rate earned on marketable Treasury securities. Subsidy costs are recognized as expenses in the year loans are disbursed and are re-estimated each year. SFA and the Department are consistent with FASAB Standard 2 in its treatment of pre-1992 loan receivables and loan guarantees. FASAB Standard 2 allows pre-FY 92 loan receivables and loan guarantees to be valued at net realizable value or expected value, respectively, or at the net present value of their cash flows. The Department values pre-1992 loan receivables and loan guarantees at the net present value of their cash flows.

The Department has included additional disclosure as required by FASAB's SFFAS No. 18, which is included in Note 4. Subsidy re-estimates, the interest rate re-estimate and the technical/default re-estimate are separately disclosed. A reconciliation is provided between the beginning and ending balances for the subsidy cost allowance for direct loans and the liability for loan guarantees.

Budget Authority

Budget authority is the authorization provided by law for SFA to obligate for future outlays of Federal funds. SFA's budgetary resources as of September 30, 2001 and 2000 include current authority (e.g. appropriations and borrowing authority) and unobligated balances remaining from multi-year and no-year budget authority received in prior years. Budgetary resources include reimbursements received and other revenue (e.g. spending authority from offsetting collections credited to an appropriation account and recoveries of prior year obligations). Pursuant to Public Law 101-510, unobligated balances associated with appropriations expiring at the end of the FY remain available only for obligation adjustment, until the account is cancelled after five years.

Borrowing from Treasury provides most of the funding for the loans' principal made under the Federal Direct Student Loan Program. The costs of SFA's programs are generally funded with congressional appropriations. Revenues are recognized from other agencies and from the public in exchange for goods or services. Major sources of reported revenue include interest income recognized from the Federal Direct Student Loan Program borrowers on outstanding loans receivable and interest accrued from Treasury on undisbursed fund balances.

Fund Balance with Treasury

Fund Balance with Treasury is the aggregate amount of funds in accounts with Treasury for which SFA is authorized to make expenditures and pay liabilities (see Note 2). Fund Balance with Treasury is an asset because it represents SFA's claim to Federal Government resources. SFA has the authority to disburse Treasury funds directly to agencies and institutions participating in its programs. Treasury processes cash receipts and disbursements on behalf of SFA.

Accounts Receivable

Accounts receivable are amounts due from the public for items such as overpayments of educational assistance. In addition, SFA enters agreements with other Federal agencies that result in amounts due SFA. Accounts receivable are recorded at cost less an allowance for uncollectible amounts.

Liabilities

Liabilities represent actual and estimated amounts of funds likely to be paid by SFA resulting from transactions or events that have already occurred. SFA may not pay a liability absent budget authority to liquidate the payable. Liabilities for which budget authority has not been enacted are classified as liabilities not covered by budgetary resources. FFEL and Federal Direct Student Loan Program liabilities result from entitlements covered by permanent indefinite budget authority.

Liabilities for Loan Guarantees

The estimated liability for loan guarantees under the FFEL Program is the estimated long-term cost to SFA of its loan guarantees calculated on a net present value basis, excluding administrative costs (see Note 4). Obligations for the subsidy cost will be recorded against budget authority when a loan guarantee commitment is made. Subsidy costs are recognized as expenses in the year loans are disbursed. This cost is re-estimated each year. The re-estimation results in an increase or decrease of recognized subsidy expense.

Accrued Grant Liability

Disbursements of grant funds are made to recipients through a draw down request. Recipients may not request funds in advance of incurring the related expenditures. Therefore, an accrued grant liability is estimated at September 30, 2001, which represents estimated amounts of authorized expenditures, where a draw down has not yet been requested although the expenditure has been incurred (see Note 8). The accrued grant liability is estimated using statistical sampling methodology.

Borrowing from Treasury

Borrowings from Treasury provide funding for loans made under the Federal Direct Student Loan Program. Principal repayments are made by SFA to Treasury based on available fund balance. Interest on debt is calculated at FY end using rates set by the U.S. Treasury. Principal repayment and interest is calculated after year-end and are remitted to U. S. Treasury (see Note 5).

Annual, Sick and Other Leave

Annual leave is accrued as earned and reduced when taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. Annual leave earned but not taken, within established limits, is funded from future financing sources. Sick leave and other types of non-vested leave are expensed as taken.

Retirement Plans and Other Employee Benefits

SFA employees participate in one of two retirement programs. The majority of SFA's employees participate in the Federal Employees Retirement System (FERS), offering a savings plan, which automatically contributes one percent of pay and matches any employee contribution up to an additional four percent of pay. In addition, for employees covered under FERS, the Department also contributes the employer's matching share for Social Security. Employees covered by the Civil Service Retirement System (CSRS) are not subject to social security taxes, nor are they entitled to accrue social security benefits for the wages subject to CSRS. CSRS functions as a defined benefit pension plan. The CSRS and FERS are operated by the Office of Personnel Management (see Note 7).

Federal Employees Compensation Act

SFA accrues its portion of the estimated liability for disability benefits assigned to the agency under the Federal Employees Compensation Act by the Department of Labor (DOL). This liability is based on the net present value of estimated future payments as computed by DOL.

Net Position

Net position is comprised of unexpended appropriations and cumulative results of operations (see Note 9). Unexpended appropriations include undelivered orders and unobligated balances, excluding activity of the liquidating and financing accounts required under the Federal Credit Reform Act of 1990. Cumulative results of operations represent the net results of operations since inception.

Prior Period Adjustments

Prior period adjustments are included in the calculation of the net change in cumulative results of operations. Prior period adjustments reflect accounting changes with retroactive effects and the correction of errors from prior periods.

Related Party Transactions

SFA's financial activities interact with and are dependent upon those of the Federal Government as a whole. Specifically, SFA is subject to financial decisions and management controls of the Department of Education, the Office of Management and Budget, and the Department of the Treasury. Because of SFA's relationship with other Federal Government entities, SFA's operations may not be conducted, nor its financial position reported, as they would if SFA were a separate and unrelated party.

Property and Equipment

The costs associated with the implementation of SFA's FMS new financial management system were capitalized at $14.5 million in accordance with the Statement of Federal Financial Accounting Standard No.10 which requires the capitalization of the costs of internally developed software. These costs will be amortized on a straight-line basis over a period of three years in accordance with Department of Education policy.

Reclassifications

The reclassification adjustments were made to the September 30, 2000 balance sheet and statement of budgetary resources and statement of financing to enhance the usefulness of presenting comparative statements.

Amounts were reclassified from "liabilities for loan guarantees" to "credit program receivables, net" to align the present value of future cash flows for the FFEL program between defaults that have already occurred and future defaults.

Beginning obligations were reduced for the FFEL program to conform the re-estimate process to those used in 2001. The reduction of the obligated balance and the corresponding increase in the unobligated balance reflects that a budgetary accounting event only occurs when an actual re-estimate is executed.

Note 2 - Fund Balance with Treasury

Fund Balance with Treasury represents all undisbursed account balances for SFA that are held by Treasury. All undisbursed account balances with Treasury are entity assets and primarily consist of appropriated and revolving funds. Revolving funds conduct continuing cycles of business-like activity and do not require an annual appropriation. SFA's fund balances with Treasury as of September 30, 2001 and September 30, 2000 were as follows (dollars in thousands):

Fund Balance with Treasury

Fund Type	FY 01 Total	FY 00 Total
Appropriated Funds	$10,054,831	$ 10,718,303
Revolving Funds	7,133,936	12,039,310
Other Funds	7,563	478
Fund Balance with Treasury	**$17,196,330**	**$ 22,758,091**

The Fund Balance with Treasury within the financing accounts of the Direct Loan and FFEL programs represent SFA's Revolving funds. Appropriated funds receive periodic, usually annual, appropriations.

Note 3 - Accounts Receivable and Guaranty Agency Reserves

Accounts receivable is recorded at the net realizable amount. SFA estimates an allowance for loss on uncollectible accounts based on historical data. Entity accounts receivable of $116 million and $10.4 million represent balances due from recipients as of September 30, 2001 and September 30, 2000 respectively, for financial assistance and for other operational activities.

Non-entity accounts receivable of $2.5 billion relates to the guaranty agency reserves. These guaranty agency reserves represent the Federal Government's interest in the net assets of state and non-profit FFEL program guaranty agencies. (In addition, since these monies are due to Treasury once received, a corresponding payable was recorded.)

The HEA amendments of 1998 required each guaranty agency to establish a Federal Student Loan Reserve Fund (Federal Fund) and an Operating Fund to pay costs incurred under the FFEL program. Federal funds and any non-liquid assets developed or purchased with Federal funds are considered property of the Federal Government. Operating funds, except for funds borrowed from the Federal Fund, are considered property of the guaranty agency. Federal statute mandates the deposits into and uses of the Federal Fund and specified deposits into the Operating Fund. Deposits into the Federal Fund are from FFEL program sources, such as payments received from the Department for reinsurance on loans, collections from borrowers equal to the complement of the reinsurance percentage, and insurance premiums collected from borrowers. A guaranty agency may only use the Federal Fund to pay insurance claims to lenders and default aversion fees to the agency's Operating Fund. Guaranty agencies generally use the Operating Fund to fulfill its other FFEL program responsibilities.

Guaranty agency reserves and federal fund balances are recorded as Other Government Assets. They are considered non-entity assets. Guaranty agency reserves and federal fund balances are also a liability due to the U.S. Treasury and are considered intragovernmental liabilities. Guaranty agency reserves and federal fund balances represent the Federal government's interest in the net assets of state and non-profit FFEL Program Guaranty Agencies.

Note 4 Credit Program Receivables and Liabilities for Loan Guarantees

The SFA operates the William D. Ford Direct Student Loan and Federal Family Education Loan (FFEL) programs to help students finance the costs of higher education. Under the programs, the SFA makes loans directly or guarantees all or a portion of loans made by participating lending institutions to individuals who meet statutorily set eligibility criteria and attend eligible institutions of higher education. Eligible higher education institutions include public and private two- and four-year institutions, graduate schools, and vocational training schools. Students and their parents receive loans regardless of income; student borrowers who demonstrate financial need also receive Federal interest subsidies.

Under the Direct Loan program, the Federal Government makes loans directly to students and parents through participating schools. Loans are originated and serviced through contracts with private vendors. Under the FFEL program, over 4,000 financial institutions make loans directly to students and parents. FFEL loans are guaranteed by the Federal Government against default, with 36 State or private non-profit guaranty agencies acting as intermediaries in administering the guarantees. Beginning with loans first disbursed on or after October 1, 1993, financial institutions became responsible for 2 percent of the cost of each default; guaranty agencies also began paying a portion of the cost (in most cases 5 percent) of each defaulted loan from Federal funds they hold in trust. FFEL participants receive statutorily set Federal interest and special allowance subsidies; guaranty agencies receive fee payments as set by statute. In most cases, loan terms and conditions under the two programs are identical.

The Federal Credit Reform Act of 1990 (the Act) governs the proprietary and budgetary accounting treatment of direct and guaranteed loans. The long-term cost to the government for direct loans or loan guarantees is referred to as "subsidy cost." Under the Act, subsidy costs for loans obligated beginning in FY1992 are recognized at the net present value of projected lifetime costs in the year the loan is disbursed. Subsidy costs are revalued annually. Components of subsidy include interest subsidies, defaults, fee offsets, and other cash flows. Consistent with the Act, subsidy cash flows exclude direct Federal administrative expenses; however, contractual payments to third-party private loan collectors, who receive a set percentage of amounts they collect, are included in these cash flows.

The Department/SFA estimates all future cash flows associated with Direct Loans and FFEL. Projected cash flows are used to develop subsidy estimates, which, as noted above, represent the net present value of future Federal costs associated with direct loans and defaulted guaranteed loans. Subsidy costs can be positive or negative; negative subsidies occur when expected program inflows (e.g., repayments, fees) exceed expected Federal costs. Subsidy estimates are recorded as a change to direct and defaulted FFEL program loans receivable and the liability for guaranteed loans. The Department working with SFA uses a computer-based cash flow projection model to calculate subsidy estimates for direct loans and defaulted guaranteed FFEL program loans, and for the FFEL program loan guarantee liability. Cash flows are projected over the life of the loan, aggregated by loan type, cohort year, and risk category. The loan's cohort year represents the year a direct loan was obligated or a loan was guaranteed, regardless of the timing of disbursements. Risk categories include two-year colleges, freshmen and sophomores at four-year colleges, juniors and seniors at four-year colleges, graduate schools, and proprietary schools.

In recent years, the consolidation of existing loans into new direct or guaranteed loans has increased significantly. Under the Act and requirements provided by OMB Circulars A-11 (Budget Formulation) and A-34 (Budget Execution), the retirement of loans being consolidated is considered a receipt of principal and interest, even though no cash is received from the borrower because a new consolidated loan is created. Under this definition of collections, defaults on loans in any given cohort are reduced in that refinancing provides payment of defaulted loans in the cohort and opens new loans in a current cohort. This consolidation activity and resulting refinancing is taken into consideration in setting the subsidy rate for defaults.

The FFEL estimated liability for loan guarantees is reported at the present value of estimated net cash outflows. Defaulted FFEL loans are reported net of an allowance for subsidy computed using net present value methodology, including defaults, collections, and other cancellations. The same methodology is used to estimate the allowance on direct loan receivables.

SFA disbursed $18 billion in Direct Loans to eligible borrowers in FY2001 and $16 billion in loans in FY2000. Half of all volume is obligated in the fourth quarter of the FY. Loans typically disburse in multiple installments over an academic period; as a result, multiple loan disbursements for a cohort year often cross FYs. Regardless of the FY in which they occur, disbursements are tracked back to the cohort of obligation.

As of September 30, 2001 and 2000, the total principal balance outstanding of guaranteed loans held by lenders was approximately $160 billion and $146 billion, respectively. As of September 30, 2001 and 2000, the maximum government exposure on outstanding guaranteed loans held by lenders was approximately $157 billion and $143 billion, respectively. Of the insured amount, SFA would pay a smaller amount to the guaranty agencies, based on the appropriate reinsurance rates, which range from 100 to 95 percent. Any remaining insurance not paid as reinsurance would be paid to lenders by the guaranty agencies from their Federal funds. Payments by guaranty agencies do not reduce government exposure, however, since these payments are made from Federal funds. The liability and allowance estimates on the SFA's books are independent of these guaranty agency Federal funds, since they are considered outside the direct or indirect control of the Secretary.

SFA accrues interest on its outstanding performing direct loans. In accordance with SFFAS No. 1, *Selected Assets and Liabilities*, the Department accrues, but does not report, interest on non-performing loans. Given SFA's comprehensive compromise authority, there is limited expectation of collection of accrued interest and fees on defaulted loans. Collections from borrowers are allocated to principal, interest, and fees, as appropriate. Non-performing loans have been in default an average of four years before they are assigned to the Department. Program data indicate that significant collections are made later in the life of non-performing student loans.

As previously noted, borrowers may pre-pay and close out existing loans without penalty from capital raised through the disbursement of a new consolidation loan. The loan liability and net receivable include estimates of future prepayments of existing loans; they do not reflect costs associated with anticipated consolidation loans.

Credit Program Receivables

The Department working with SFA reclassified $3.6 billion for FY 2000 from liabilities for loan guarantees for FFEL to credit program receivables to align the allowance for subsidy to the expected value under credit reform. This reclassification did not result in program cost or additional subsidy. Credit program receivables are comprised of direct and defaulted FFEL loan principal and related interest receivable, net or inclusive of the allowance for subsidy. The credit program receivables are as follows:

Direct Loan Program Credit Program Receivables

at September 30

(Dollars in Thousands)

	FY2001	**FY2000**
Principal Receivable	$ 70,544,902	$ 58,522,455
Interest Receivable	2,615,855	1,707,927
Sub-total	**$ 73,160,757**	**$ 60,230,382**
Allowance for Subsidy	1,568,317	2,585,250
Credit Program Receivable, Net	**$ 74,729,074**	**$ 62,815,632**

The allowance for subsidy for Direct Loans is a negative (debit) balance due to high interest payment projections on SFA receivables such that total projected principal and interest received will exceed the face value of the loan receivables.

FFEL Program Credit Program Receivables

at September 30

(Dollars in Thousands)

	FY2001			FY2000		
	Pre-1992	Post-1991	Total	Pre-1992	Post-1991	Total
Principal Receivable	$14,120,871	$5,366,538	$19,487,409	$14,986,951	$5,341,825	$20,328,776
Interest Receivable	1,740,152	1,286,825	3,026,977	2,006,678	1,188,792	3,195,470
Sub-total	**$15,861,023**	**$6,653,363**	**$22,514,386**	**$16,993,629**	**$6,530,617**	**$23,524,246**
Allowance for Subsidy	(14,488,687)	(2,438,910)	(16,927,597)	(14,086,594)	(2,186,537)	(16,273,131)
Credit Program Receivable, Net	**$ 1,372,336**	**$ 4,214,453**	**$ 5,586,789**	**$ 2,907,035**	**$4,344,080**	**$ 7,251,115**

Direct Loan Program Reconciliation of Allowance for Subsidy

The reconciliation of allowance for subsidy for the Direct Loan Program follows:

Direct Loan Reconciliation of Allowance for Subsidy

(Dollars in Thousands)

	FY2001	FY2000
Beginning Balance, Allowance for Subsidy	$2,585,250	($1,557,854)
Components of Subsidy Transfers		
Interest Rate Differential	$2,204,550	$1,880,221
Default, Net of Recoveries	(597,850)	(784,166)
Fees	243,567	341,472
Other	(811,259)	(368,877)
Current Year Subsidy Transfers from Program Account	$1,039,008	$1,068,650
Components of Subsidy Re-estimates		
Interest Rate Re-estimates	$875,608	$378,049
Technical and Default Re-estimates	(3,221,618)	2,486,229
Total Subsidy Re-estimates	$(2,346,010)	$2,864,278
Activity		
Fee Collections	$(315,040)	$(360,570)
Loan Cancellations[1]	342,897	89,793
Subsidy Allowance Amortization	161,748	459,522
Other	100,464	21,431
Total Activity	$290,069	$210,176
Ending Balance, Allowance for Subsidy	$1,568,317	$2,585,250

[1]Loan cancellations include those loans where the primary borrower has died, become disabled or declared bankruptcy.

Liabilities for Loan Guarantees

Liabilities for loan guarantees represent the net present value of future projected cash flows, including principal and interest repayments. As such, these estimates vary significantly with changes in forecasting assumptions; particularly involving the interest rates charged to students, those paid to loan holders, and those used for discounting cash flows. The FY2001 and FY2000 liabilities were calculated using government-wide interest rate projections provided by the Office of Management and Budget.

FFEL Program Reconciliation of Liabilities for Loan Guarantees

The FFEL Program loan guarantee liability reconciliation, associated with the FFEL Program loans guaranteed in the financing account are as follows:

FFEL Program Guarantee Liability Reconciliation

(Dollars in Thousands)

	FY2001	FY2000
Beginning Balance, Liability for Loan Guarantees	$9,534,955	$8,250,606
Components of Subsidy Transfers		
Interest Supplement Costs	$2,671,860	$2,816,347
Defaults, Net of Recoveries	954,195	1,267,680
Fees	(1,371,175)	(1,067,127)
Other	854,129	513,234
Current Year Subsidy Transfers from Program Account	$3,109,009	$3,530,134
Components of Subsidy Re-estimates		
Interest Rate Re-estimates	$ (43,022)	$ (412)
Technical and Default Re-estimates	(2,864,956)	(1,283,104)
Subsidy Re-estimates in Liability	$(2,907,978)	$(1,283,516)
Activity		
Interest Supplement Payments	$(3,343,333)	$(3,108,557)
Claim Payments	(2,568,548)	(1,858,902)
Fee Collections	1,392,343	1,254,210
Interest on Liability Balance	460,717	499,843
Other[1]	2,549,042	2,251,137
Total Activity	$(1,509,779)	$(962,269)
Ending Balance, Liabilities for Loan Guarantees	$8,226,207	$9,534,955
FFEL Liquidating Account Liabilities for Loan Guarantees	150,560	443,713
Total Liabilities for Loan Guarantees	$8,376,767	$9,978,668

(1) Includes amounts recorded to the liability balance for collections on defaults, adjustments, and loan consolidation activity. The adjustments include reclassifications between the liability for Loan Guarantees and the Allowance for Subsidy for FY 2001 and FY 2000.

Subsidy Expense

Direct Loan and FFEL Program loan guarantee subsidy expenses are as follows:

Direct Loan Program Subsidy Expense
For the FYs Ending September 30
(Dollars in Thousands)

	FY2001	FY2000
Interest Rate Differential	$(2,204,550)	$(1,880,221)
Defaults, Net of Recoveries	597,850	784,166
Fees	(243,567)	(341,472)
Other	811,259	368,877
Current Year Subsidy Transfers	**$(1,039,008)**	**$(1,068,650)**
Re-estimates	2,346,010	(2,864,278)
Direct Loan Subsidy Expense	**$1,307,002**	**$(3,932,928)**

FFEL Program Loan Guarantee Subsidy Expense
For the FYs Ending September 30
(Dollars in Thousands)

	FY2001	FY2000
Interest Supplement Costs	$ 2,671,860	$ 2,816,347
Defaults, Net of Recoveries	954,195	1,267,680
Fees	(1,371,175)	(1,067,127)
Other	854,129	513,234
Current Year Subsidy Transfers	**$ 3,109,009**	**$ 3,530,134**
Re-estimates	(3,423,314)	(3,234,603)
FFEL Loan Guarantee Subsidy Expense	**$ (314,305)**	**$ 295,531**

Subsidy Rates

The subsidy rates are used to compute each year's subsidy expense disclosed on the Statement of Net Cost. The subsidy rates applicable to the 2001 loan cohort year are as follows:

Subsidy Rates
Applicable to 2001 Loan Cohort Year

	Interest Differential	Defaults	Fees	Other	Total
Direct Loan Program, Cohort 2001	(10.31%)	2.64%	(1.18%)	4.39%	(4.46%)
	Interest Supplements	**Defaults**	**Fees**	**Other**	**Total**
FFEL Program, Cohort 2001	7.79%	2.47%	(4.40%)	2.81%	8.67%

The subsidy rates disclosed pertain only to the cohort listed. These rates cannot be applied to direct or guaranteed loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new direct or guaranteed loans reported in the current year relate to disbursements of loans from both current and prior years' cohorts. Subsidy expense is recognized when direct loans are disbursed by the SFA or guaranteed loans are disbursed by third-party lenders.

Administrative Expenses

The reported salaries and administrative expenses include the allocation of direct and indirect administrative costs among the reporting groups.

Administrative Expenses

For FYs Ending September 30

(Dollars in Thousands)

	Direct Costs		Indirect Costs		Total Costs	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
SFA	$52,998	$50,580	$72,263	$63,131	$125,261	$113,711

Note 5 - Borrowing from Treasury

Borrowing from Treasury funds the majority of the loans made under the Direct Loan Program. The Interest rate is set each year by Treasury. Borrowing from Treasury as of September 30, 2001 and September 30, 2000 was as follows:

Borrowing from Treasury (dollars in thousands)

	FY 2001	FY 2000
Borrowing from Treasury, Beginning	$65,346,881	$ 52,069,506
New Borrowing	20,703,739	16,346,598
Repayments	(8,861,515)	(3,069,223)
Borrowing from Treasury, Ending	**$77,189,105**	**$ 65,346,881**

Unused Borrowing Authority as of September 30, 2001 and September 30, 2000 was as follows (dollars in thousands):

Unused Borrowing (dollars in thousands)

	FY 2001	FY 2000
Unused Borrowing from Treasury, Beginning	$4,770,736	$1,505,188
Current Year Borrowing Authority	21,794,507	19,612,146
Realized Borrowing from Treasury	(20,703,739)	(16,346,598)
PY Unused Borrowing Authority Cancelled	(2,318,678)	0
Ending Unused Borrowing	**$3,542,826**	**$4,770,736**

Fund Balance with Treasury was reduced by approximately $8.9 billion and $3.0 billion respectively for FYs 2001 and 2000 because of principal repayments of borrowing made to Treasury pertaining to the Direct Loan Program. The Statement of Budgetary Resources reflects the budgetary impact of the principal repayment to Treasury.

Additionally, Fund Balance with Treasury was reduced by $5.1 billion for interest expense and increased by $1.1 billion for interest revenue, pertaining to the interest calculations of the Direct Loan Program for FY 2001. The Statement of Net Cost for FY 2001 reflects the $5.1 billion of interest expense as well as the interest revenue on uninvested funds of $1.1 billion. The Statement of Budgetary Resources for FY 2001 reflects expenditure outlays of $13.3 billion. This interest expense and revenue consisted of expenditure transactions (SF-1081) that were submitted in October 2001 and were reflected on the September Statement of Transactions (SF-224). Treasury regulations require interest payments to be paid to Treasury annually, as of the last day of the FY, and are due to Treasury no later than the third workday after the close of the FY. SFA reduced Fund Balance with Treasury in compliance with Treasury regulations as of September 30, 2001 and 2000, to address this issue.

Note 6 - Payable to Treasury

At September 30, 2001 and 2000, SFA reported $4.2 billion and $7.9 billion respectively, as payable to the U.S. Treasury. For the FFEL liquidating account SFA includes a payable to Treasury equivalent to the net cash inflows for the remaining life of the program; for FY 2001, this amount was $1.5 billion, for FY 2000 this amount was $3.9 billion. A payable to Treasury is also included for the downward re-estimates of subsidy needs for existing loan cohorts in the financing accounts. In FY 2001 the FFEL financing account the amount was $2.7 billion. For FY 2000 the amount was $4 billion.

SFA pays downward re-estimates in the year they are executed in the Budget, usually the following FY after financial statement accrual. The payable to Treasury consisted of the following as of September 30, 2001 and 2000 :

Payable to Treasury

(Dollars In Thousands)

	FY2001	FY2000
Future Excess Liquidating Account Collections - FFEL	$1,506,429	$3,850,017
FFEL Downward Subsidy Re-estimate	2,706,126	4,010,604
TOTAL	**$4,212,555**	**$7,860,621**

Note 7 - Other Liabilities

Other liabilities covered by budgetary resources include contractual services, administrative services, and interagency agreement accruals. Other liabilities not covered by budgetary resources include unfunded expenses that will be paid out of future budgetary resources. SFA's other liabilities as of September 30, 2001 were as follows (dollars in thousands):

Other Liabilities
(dollars in thousands)

	FY 2001	FY2000
Other Liabilities Covered by Budgetary Resources:		
Intragovernmental	$ 0	$ 4
Governmental	109,341	145,759
Total – Covered	$ 109,341	$ 145,763
Other Liabilities Not Covered by Budgetary Resources:		
Intragovernmental	$ 980	$ 237,682
Governmental	10,596	9,342
Total-Not Covered	$ 11,576	$ 247,024
Total	$ 120,917	$ 392,787

Note 8 - Accrued Grant Liability

Disbursements of grant funds are made to recipients through a draw down request. Since some recipients did not request funds in advance of incurring related grant expenditures, an accrued grant liability of $899 million was estimated for September 30, 2001 and $319 million for September 30, 2000. The accrued grant liability represents an estimate of the expenses incurred by grantees that have not yet been reimbursed. For FY 2000, the total liability was estimated from data reported from a random sample of grant awards and allocated among the reporting groups based on the grant balance available at FY-end. For FY 2001, the sample of grant awards was updated to support estimates at the reporting group level, an improvement that effectively eliminated the need for allocation of the grant liability estimate.

Note 9 - Net Position

SFA's net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations represent amounts authorized by Congress not yet expended, which have not lapsed, been rescinded, or been withdrawn. Balances Not Available are those that are non-apportioned for use by OMB. Cumulative results of operations represent the net difference between 1) the expenses and losses and 2) the financing sources, including revenues and gains since the inception of the activity.

SFA's unexpended appropriations are comprised of unobligated balances-available, unobligated balances-unavailable, and undelivered orders. Since unexpended appropriations do not include funding activity for which appropriations have not yet been received, unexpended appropriations reported on the Balance Sheet will not agree with the balances of budget authority. The unobligated balances and undelivered orders for SFA's financing and liquidating accounts are not included in unexpended appropriations. Total unobligated balances not included in unexpended appropriations include $5.2 billion for the FFEL Program and $2.5 million for the Direct Loan Program. SFA's unexpended appropriations as of September 30, 2001 and September 30, 2000 are comprised of the following:

Unexpended Appropriations
(dollars in thousands)

Unobligated Balance	FY2001	FY2000
-Available	**$1,288,707**	**$1,491,476**
-Unavailable	**211,689**	**174,625**
Undelivered orders	**7,238,398**	**7,586,909**
Unexpended Appropriations	**$8,738,794**	**$ 9,253,010**

SFA's cumulative results of operations consist primarily of unfunded expenses for certain payroll accruals and the net upward re-estimate for the Direct Loan Program in FY 2001. These expenses are funded from future appropriations and the cumulative results of operations will be reversed when funding occurs.

Undelivered orders and unobligated balances for Federal credit financing and liquidating funds are not included in the chart above, as they are not funded through appropriations. As a result, unobligated and undelivered order balances in the above chart will differ from these balances contained in the Combined Statement of Budgetary Resources.

Note 10 - Interest Revenue and Expense

Federal interest revenue was earned on the uninvested fund balances with Treasury for the portfolios of the direct loan and FFEL programs. Direct loan non-federal and federal interest is earned on individual non-defaulted loans. Interest expense was incurred on SFA's borrowings from Treasury for the Federal Direct Loan Program. For the FFEL program Federal interest revenue is earned on the uninvested fund balance as loan repayments from defaulted loans are deposited with the U.S. Treasury. The interest revenues and expenses attributable to the Federal Direct Student Loan and FFEL programs follow for FY 2001 and FY 2000:

Interest Revenues and Expenses FY 2001 (dollars in thousands)				
	Federal Direct	**FFELP**	**Grants**	**Total**
Interest Revenues, Federal	$1,061,471	$460,717		$1,522,188
Interest Revenues, Non-Federal	4,039,690			4,039,690
Interest Revenues	**$5,101,161**	**$460,717**		**$5,561,878**
Interest Expense, Federal	$5,101,161	$460,717	$ 0	$5,561,878
Interest Expense, Non-Federal	183	159	16	358
Interest Expense	**$5,101,344**	**$460,876**	**$16**	**$5,562,236**

The increase in interest expense is related to the increase in borrowing from Treasury by the Department. Similarly, the increase in interest revenue is related to increased borrowing as the Department earns interest on undisbursed funds borrowed from Treasury.

Interest Revenues and Expenses FY 2000 (dollars in thousands)			
	Federal Direct	**FFELP**	**Total**
Interest Revenues, Federal	$1,261,281	$499,843	$1,761,124
Interest Revenues, Non-Federal	3,211,256	0.00	3,211,256
Interest Revenues	**$ 4,472,537**	**$499,843**	**$4,972,380**
Interest Expense, Federal	$ 4,472,537	$499,843	$4,972,380
Interest Expense, Non-Federal	115	109	224
Interest Expense	**$4,472,652**	**$499,952**	**$4,972,604**

Note 11 - Allocation of Direct and Indirect Cost

Total program costs for FY 2001 and FY 2000 of $18.3 billion and $11.2 billion respectively includes $72.3 million and $63.1 million in allocated indirect departmental expenses and $53 million and $50.5 million of direct costs respectively. The Department, in support of SFA programs, incurs expenses for salaries and administrative activities that are allocated to SFA based on full time employee counts and program dollars.

Note 12 - Imputed Costs and Financing Sources

The Statement of Changes in Net Position recognized an imputed financing source of $129.4 million and $117.6 million respectively for FYs 2001 and 2000. A corresponding post-employment benefit expense is recognized on the Statement of Net Cost as a program cost under salaries and administrative expense. Also included is the cost allocation to SFA from the Department as part of the imputed costs. The imputed financing source represents annual service costs not paid by SFA or employee contributions to the Civil Service Retirement System. No imputed financing source is recognized for the Federal Employee Retirement System, since it is a fully funded retirement service plan. The post-employment benefit expense represents SFA's estimate of the funds necessary to pay employees future pension, life, and health benefits.

Note 13 – Prior Period Adjustments

During FY 2001 and FY 2000, the SFA performed various analyses of its account balances in an effort to improve the financial data recorded in its accounting system. Items of income and expense related to prior periods were recorded as prior period adjustments and net position was amended to reflect the adjustments.

During FY 2001, the Department made prior period adjustments to:

- Adjust cumulative results of operations account balances based on an analysis of unfunded liabilities and capitalized assets.
- Align Fund Balance with Treasury and budgetary accounts comprising unobligated balances, undelivered orders, and accounts payable and receivable.
- Make adjustments to account balances resulting from reconciliations of subsidiary systems to general ledger balances.

During FY 2000, ED/SFA reconciled its undelivered order balances between its general ledger and the GAPS payment system, disbursement in transit account balances, and its fund balance with treasury to the budgetary status of resource accounts. In addition, it reviewed the FFEL financing fund to correct the cumulative results of operations account balance. Prior period adjustments were made based on these analyses.

Prior Period Adjustments to Net Position For FYs Ending September 30

(Dollars in Thousands)

	Totals	
	FY 2001	FY 2000
FFEL	$ 69	($824,645)
DL	50	(20,694)
SFA Grants	(48,462)	(85,716)
Totals	$(48,343)	$(931,055)

Note 14 – Unobligated and Obligated Balances

During FY 2001 and FY 2000, the Department performed a review of unobligated and obligated balances and recorded adjustments to the beginning account balances. The Statement of Budgetary Resources reflects the adjusted beginning unobligated and obligated balances, and the related adjustments to obligations incurred during the period.

The FY 2001, adjustments to the beginning obligated balances resulted from an analysis of the budgetary and proprietary accounts payable balances. Adjustments to the prior year's posting logic resulted in changes to the beginning obligated balances. Additionally, the FY 2001 beginning obligated and unobligated balances were adjusted due to systematic problems in the general ledger closing process and other accounting problems that occurred in prior years.

Finally the difference between the FY 2000 ending and the FY 2001 beginning unadjusted unobligated balance is the result of a transfer of a $24 million prior year unobligated balance to the Department of Labor.

The Statement of Budgetary Resources reflects the following adjusted beginning unobligated balances for FY 2001:

	FY 2001 Beginning Balance (Unadjusted)	Adjustments	FY 2001 Beginning Balance (Adjusted)
Unobligated Balances (dollars in thousands)			
FFEL	$ 8,173,288	$6,774	$ 8,180,062
DL	22,960	(17,969)	4,991
Grants	1,652,835	41,184	1,694,019
Total	**$ 9,849,083**	**$ 29,989**	**$ 9,879,072**

During FY 2000, the Department/SFA performed a review of beginning balances and recorded adjustments to correct the account balances. The Statement of Budgetary Resources reflects the following adjusted beginning unobligated balances (dollars in thousands) for FY 2000:

	FY 2000 Beginning Balance (Unadjusted)	Adjustments	FY 2000 Beginning Balance (Adjusted)
Unobligated Balances (dollars in thousands)			
FFEL	$ 7,771,917	$ 498,922	$ 8,270,839
DL	29,794	0	29,794
Grants	4,720,204	182,208	4,902,412
Total	**$ 12,521,915**	**$ 681,130**	**$ 13,203,045**

Obligated Balances – Beginning of the Period at September 30

(Dollars in Thousands)

	Beginning Balance (Unadjusted)		Adjustments		Beginning Balance (Adjusted)	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
FFEL	$3,878,875	$3,060,836	$(170,661)	$745,255	$3,708, 214	$3,806,091
DL	$7,229,151	$6,907,766	$2,291	$0	$7,231,442	$6,907,766
Grants	$6,510,518	$2,807,498	$16,126	$143,208	$6,526,644	$2,950,706
Totals	$17,618,544	$12,776,100	$(152,244)	$888,463	$17,466,300	$13,664,563

Obligations Incurred

(Dollars in Thousands)

	Beginning Balance (Unadjusted)		Adjustments		Beginning Balance (Adjusted)	
	FY2001	FY2000	FY2001	FY2000	FY2001	FY2000
FFEL	$15,004,142	$11,560,310	$170,661	($745,255)	$15,174,803	$10,815,055
DL	$27,882,115	$ 24,521,127	($2,291)	$0	$27,879,824	$ 24,521,127
Grants	$11,709,192	$12,921,838	$(14,024)	$(143,208)	$11,695,168	$12,778,630
Totals	$54,595,449	$49,003,275	$154,346	$(888,463)	$54,749,795	$48,114,812

Note 15 - Statement of Budgetary Resources

The Statement of Budgetary Resources compares budgetary resources with the status of those resources. The Statement of Budgetary Resources is a simplified version of the statutory "Report on Budget Execution" (SF-133) that is required to be submitted to Treasury on a quarterly basis. The Report on Budget Execution is used annually to prepare the President's Budget and it is integral to Federal budgeting. SFA's budgetary resources consist of budget authority, unobligated balances, transfers of monies, collections, and recoveries of prior year obligations, which is net of amounts temporarily or permanently not available. SFA's budget authority is authority provided by law for SFA to incur financial obligations that will result in outlays or expenditures.

Budgetary Resources

Budgetary resources outstanding as of September 30, 2001 were $61.5 billion and outlays for the year were $24.5 billion. At September 30, 2001, SFA had $(14.0) billion in net budgetary resources obligated for undelivered orders consisting of $(2.5) billion in the Federal Family Education Loan (FFEL) Program and $(4.3) billion in the Federal Direct Student Loan Program, and $(7.2) billion in the Pell Grant Program. An undelivered order is an amount of goods and services ordered from another Federal agency or the public but not yet received, i.e., the amount of orders for goods and services outstanding for which the liability has not yet accrued. The SFA reviewed its obligated balances for the Direct Loan Program resulting in a downward adjustment to the beginning obligated balance of $4.6 billion in FY 2001. This downward adjustment of the obligations resulted in the return and cancellation of repayment on Treasury borrowing of $2.3 billion and the repayment of $2.3 billion on Treasury borrowing.

Borrowing authority is a budgetary resource used to fund loans made under the Direct Loan Program. Borrowing authority is granted to a Federal entity to borrow and to obligate and expend the borrowed funds. The Direct Loan Program may borrow from Treasury to fund loans originated during the year. The available borrowing authority remaining for Direct Loan Program for loans originated during FY 2001 was $3.5 billion. Borrowing from Treasury cannot exceed the amount apportioned by the Office of Management and Budget during a given year. Borrowings may be repaid to Treasury at any time without penalty and funds not expended accrue interest as uninvested funds. The majority of the funds used to repay Treasury borrowings are collections on outstanding loans.

The Federal Direct Student Loan Program and the FFEL Program were granted permanent indefinite appropriation budget authority through legislation. Part D of the William D. Ford Federal Direct Loan Program and Part B of the Federal Family

Education Loan Program, pursuant to the HEA of 1965, pertains to the existence, purpose, and availability of this permanent indefinite appropriations authority.

Adjustments

Per OMB Bulletin 01-09 the "Adjustments" line item on the Statement of Budgetary Resources includes repayments of borrowings, negative subsidy returns, and excess collections returned to Treasury.

Adjustments for direct loans for this line item totaled $8.3 billion in FY 2001. In the Financing fund, repayments to Treasury totaled $6.6 billion. In the Program Fund, $1.7 billion of collections from the downward negative/negative subsidy were returned to the Treasury Department.

Adjustments to FFEL for this line item totaled $5.9 billion in FY 2001. In the liquidating fund, excess collections from borrowers to Treasury totaled $1.6 billion. In the program fund, capital transfers (repayment of downward estimate to Treasury) totaled $4.7 billion, offset by approximately $800 million in recoveries. In addition, adjustments were made in preparing both the FY 2001 and the FY 2000 Statement of Budgetary Resources to the beginning obligated and unobligated balances.

Comparison to the Budget of the United States Government

Differences exist between the Statement of Budgetary Resources and the FY 2001 actual amounts reported in the Budget of the United States Government. These differences are not material and relate to the use of all appropriations (current and expired) for the Statement of Budgetary Resources versus only current year appropriations for the Budget of the United States Government. In addition, the Budget of the United States Government includes information and estimates that pre-date the completion of the Department's audited financial statements.

Note 16 - Statement of Financing

The Statement of Financing provides information on the total resources used by an agency, both those received through the budget and those received through other means, during the reporting period. It then explains how they were used in agency operations to finance orders for goods and services not yet delivered, to acquire assets and liabilities, and to fund the entity's net cost of operations (expenses less exchange revenue, or earned revenues from providing goods and services).

Cash flows associated with credit programs flow through the liability for loan guarantees or the allowance for subsidy. These flows, unlike other accounts, are not recorded as revenues or expenses and do not impact the Department's net cost of operations. In addition, special circumstances surround unfunded expenses such as upward subsidy re-estimates, accrued annual leave, and other payroll-related accruals. These unfunded expenses affect the Statement of Net Cost but are not covered by budgetary resources (i.e., do not give rise to a budgetary accounting event). Liabilities not covered by budgetary resources were $11.6 million and $247 million as of September 30, 2001and 2000 respectively.

Note 17 - Perkins Loans Reserve Funds

The Perkins Loan Program is a campus-based program providing financial assistance to eligible postsecondary school students. SFA provides funds to participating schools to provide about 85.5 percent of the capital used to make loans to eligible students at 5 percent interest. The remaining 14.5 percent of program funding is provided by the school. For the latest academic year ended June 30, 2001, there were approximately 620,000 loans made, totaling approximately $1.1 billion at approximately 1,761 institutions, averaging $1,790 per loan. For the academic year ended June 30, 2000, there were approximately 653,000 loans made, totaling approximately $1.1 billion at approximately 1,817 institutions averaging $1,700 per loan. SFA's share of the Perkins Loan Program was approximately $6.1 billion as of September 30, 2001 and approximately $6.2 billion as of September 30, 2000.

Perkins Loan borrowers who meet statutory eligibility requirements—such as service as a teacher in low-income areas, as a Peace Corp or VISTA volunteer, in the military, or in law enforcement, nursing, or family services—may receive partial loan forgiveness for each year of qualifying service. Where there is a partial loan forgiveness a contingency exists. The SFA may be required to compensate Perkins Loan institutions for the costs of partial loan forgiveness.

Note 18 - Litigation and Other Claims

The Department is involved in various lawsuits incidental to its operations. Judgments resulting from litigation against the Department are paid by the Department of Justice. In the opinion of management, the ultimate resolution of pending litigation will not have a material effect on the Department's financial statements.

Some portion of the current year financial assistance expenses (grants) may include funded recipient expenditures which were subsequently disallowed through program review or audit processes. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Department's financial statements.

Section VII

Supplemental Information

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidating Balance Sheet
As of September 30, 2001
(Dollars in Thousands)

	Consolidated	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Assets				
Intragovernmental Assets:				
Fund Balance with Treasury (Note 2)	$17,196,330	$7,757,905	$785,901	$8,652,524
Accounts Receivable, Net (Note 3)	4,488	4,488		
Interest Receivable				
Governmental Assets:				
Accounts Receivable, Net (Note 3)	111,469	107,136	4,333	
Credit Program Receivables, Net (Note 4)	80,315,862	5,586,788	74,729,074	
Advances	38,738	38,738		
Cash and Other Monetary Assets				
Property and Equipment	17,307	7,602	8,938	767
Other Governmental Assets	258,006	257,973		33
Guaranty Agency Federal & Restricted Funds Receivable (Note 3)	2,462,445	2,462,445		
Total Assets	$100,404,645	$16,223,075	$75,528,246	$8,653,324
Liabilities				
Intragovernmental Liabilities:				
Accounts Payable	$3,410	$1,189	$2,045	$176
Interest Payable				
Borrowing from Treasury (Note 5)	77,189,105		77,189,105	
Guaranty Agency Federal & Restricted Funds Due To Treasury (Note 3)	2,462,445	2,462,445		
Payable to Treasury (Note 6)	4,212,555	4,212,555		
Other Intragovernmental Liabilities (Note 7)	980	693	234	53
Governmental Liabilities:				
Accounts Payable	516,097	141,791	287,409	86,897
Accrued Grant Liability (Note 8)	899,180			899,180
Liabilities for Loan Guarantees (Note 4)	8,376,767	8,376,767		
Other Governmental Liabilities (Note 7)	119,937	67,565	47,779	4,593
Total Liabilities	$93,780,476	$15,263,005	$77,526,572	$990,899
Net Position				
Unexpended Appropriations (Note 9)	$8,738,794	$960,037	$116,784	$7,661,973
Cumulative Results of Operations (Note 9)	(2,114,625)	33	(2,115,110)	452
Total Net Position	$6,624,169	$960,070	($1,998,326)	$7,662,425
Total Liabilities and Net Position	$100,404,645	$16,223,075	$75,528,246	$8,653,324

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidating Statement of Net Cost
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Consolidated	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Program Costs				
Intragovernmental				
Interest Expense, Federal (Note 10)	$5,561,878	$460,717	$5,101,161	
Other Production Expense				
Contractual Service Expense	12,869	2,758	2,169	$7,942
Salaries and Administrative Expense	95,518	36,655	36,040	22,823
Bad Debt & Write-offs				
Governmental				
Subsidy Expense (Note 4)	992,696	(314,305)	1,307,001	
Grant Expense	10,812,779			10,812,779
Interest Expense, Non-Federal (Note 10)	358	159	183	16
Contractual Service Expense	484,012	211,989	238,970	33,053
Salaries and Administrative Expense	153,427	58,086	33,803	61,538
Other Program Expenses	194,805	73,884	86,902	34,019
Total Program Cost	$18,308,342	$529,943	$6,806,229	$10,972,170
Less: Earned Revenues				
Interest, Federal (Note 10)	$1,522,188	$460,717	$1,061,471	
Interest, Non-Federal (Note 10)	4,039,690		4,039,690	
Earned Revenues	$5,561,878	$460,717	$5,101,161	
Net Cost of Operations	$12,746,464	$69,226	$1,705,068	$10,972,170

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Consolidating Statement of Changes in Net Position
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Consolidated	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Net Cost of Operations	$(12,746,464)	$(69,226)	$(1,705,068)	$(10,972,170)
Financing Sources (Other than Exchange Revenues):				
Appropriations Used	$13,466,364	$2,779,600	($152,693)	$10,839,457
Imputed Financing (Note 12)	129,421	2,682	1,361	125,378
Future Transfers Out due to Downward Subsidy Re-estimate	(2,706,125)	(2,706,125)		
Total Financing Sources	$10,889,660	$76,157	$(151,332)	$10,964,835
Net Results of Operations	$(1,856,804)	$6,931	$(1,856,400)	$(7,335)
Prior Period Adjustments (Note 13)	(48,343)	69	50	(48,462)
Net Change in Cumulative Results of Operations	$(1,905,147)	$7,000	$(1,856,350)	$(55,797)
Increase (Decrease) in Unexpended Appropriations	(514,217)	(385,856)	(7,388)	(120,973)
Change in Net Position	$(2,419,364)	$(378,856)	$(1,863,738)	$(176,770)
Net Position - Beginning of Period	9,043,533	1,338,926	(134,588)	7,839,195
Net Position - End of Period	$6,624,169	$960,070	($1,998,326)	$7,662,425

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Combining Statement of Budgetary Resources
For the Year Ended September 30, 2001
(Dollars in Thousands)

	Combined	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Budgetary Resources				
Budget Authority	$37,514,043	$3,454,474	$23,351,458	$10,708,111
Unobligated Balance-Beginning of Period (Adjusted) (Note 14)	9,879,072	8,180,062	4,991	1,694,019
Spending Authority from Offsetting Collections (Adjusted)	27,505,541	14,640,197	12,865,344	
Adjustments	(13,407,710)	(5,853,547)	(8,331,853)	777,690
Total Budgetary Resources (Note 15)	$61,490,946	$20,421,186	$27,889,940	$13,179,820
Status of Budgetary Resources				
Obligations Incurred (Adjusted) (Note 14)	$54,749,795	$15,174,803	$27,879,824	$11,695,168
Unobligated Balances-Available	1,293,179	4,711	261	1,288,207
Unobligated Balances-Not Available	5,447,972	5,241,672	9,855	196,445
Total Status of Budgetary Resources (Note 15)	$61,490,946	$20,421,186	$27,889,940	$13,179,820
Outlays				
Obligations Incurred (Adjusted) (Note 14)	$54,749,795	$15,174,803	$27,879,824	$11,695,168
Less: Spending Authority from Offsetting Collections (Adjusted)	(33,697,223)	(15,443,193)	(17,430,715)	(823,315)
Obligated Balance, Net-Beginning of Period (Adjusted) (Note 14)	17,466,300	3,708,214	7,231,442	6,526,644
Less: Obligated Balance, Net-End of Period (Adjusted)	(13,985,723)	(2,503,952)	(4,313,900)	(7,167,871)
Total Outlays (Note 15)	$24,533,149	$935,872	$13,366,651	$10,230,626

The accompanying notes are an integral part of these financial statements.

UNITED STATES DEPARTMENT OF EDUCATION
Student Financial Assistance
Combining Statement of Financing
For the Year Ended September 30, 2001

(Dollars in Thousands)

	Combined	Federal Family Education Loan Program	Direct Student Loan Program	Grant Programs
Obligations and Nonbudgetary Resources				
Obligations Incurred (Adjusted) (Note 14)	$54,749,795	$15,174,803	$27,879,824	$11,695,168
Spending Authority from Offsetting Collections and Adjustments (Adjusted)	(33,697,223)	(15,443,193)	(17,430,715)	(823,315)
Financing Imputed for Cost Subsidies	129,421	2,682	1,361	125,378
Financing Sources Transferred Out	(2,706,125)	(2,706,125)		
Exchange Revenue Not In the Entity's Budget				
Other	4,824,026	1,738,457	3,085,569	
Total Obligations and Nonbudgetary Resources	$23,299,894	$(1,233,376)	$13,536,039	$10,997,231
Resources That Do Not Fund Net Cost of Operations				
Change in Amount of Goods, Services, and Benefits Ordered But Not Yet Provided (Net Increases) Net Decreases	$3,095,274	$650,570	$2,477,101	$(32,397)
Credit Program Collections that Increase Liabilities for Loan Guarantees or Allowance for Subsidy	11,436,845	4,462,601	6,974,244	
Resources that Fund Expenses Recognized in Prior Periods	(4,311)	(4,294)	(16)	(1)
Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	(35,171,087)	(10,932,311)	(24,237,862)	(914)
Other Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	4,197,500	3,109,009	1,088,491	
Total Resources That Do Not Fund Net Cost of Operations	$(16,445,779)	$(2,714,425)	$(13,698,042)	$(33,312)
Costs That Do Not Require Resources				
Adjustments	$11,503	$1,529	$1,767	$8,207
Total Costs That Do Not Require Resources	$11,503	$1,529	$1,767	$8,207
Financing Sources Yet to be Provided	$5,880,846	$4,015,498	$1,865,304	$44
Net Cost of Operations (Note 16)	$12,746,464	$69,226	$1,705,068	$10,972,170

The accompanying notes are an integral part of these financial statements.

ERNST & YOUNG