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Testimony

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

For Release on Delivery
Expected at
9:30 a.m.
Tuesday,
July 24, 2001

FINANCIAL MANAGEMENT

Poor Internal Control Exposes Department of Education to Improper Payments

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our ongoing review of the Department of Education's payment processes and how the existing internal control weaknesses we have noted thus far make the Department vulnerable to, and in some cases have resulted in, improper payments. Improper payments include errors, such as duplicate payments and calculation errors; payments for unsupported or inadequately supported claims; payments for services not rendered or to ineligible beneficiaries; and payments resulting from fraud and abuse.

Internal control and financial management weaknesses at Education are not new. We and Education's Office of Inspector General (IG) have provided many reports and testimonies over the last several years on the financial management challenges faced by Education and the need to eliminate internal control weaknesses to reduce the potential for fraud, waste, and mismanagement at the Department.¹ In addition, since 1990 we have designated Education's student financial assistance programs as "high-risk,"² largely because of severe internal control weaknesses within those programs. Further, Education's IG reported information system general controls as a material weakness in fiscal year 2000.³ The effectiveness of general controls is a significant factor in the effectiveness of application controls.⁴ Without effective general controls, application controls may be rendered ineffective by circumvention or modification.

¹ *Financial Management: Education Faces Challenges in Achieving Financial Management Reform* (GAO/T-AIMD-00-106, March 1, 2000), *Financial Management: Education's Financial Management Problems Persist* (GAO/T-AIMD-00-180, May 24, 2000), *Financial Management: Financial Management Challenges Remain at the Department of Education* (GAO/T-00-AIMD-00-323, September 19, 2000), *Financial Management: Internal Control Weaknesses Leave Department of Education Vulnerable to Improper Payments* (GAO-01-585T, April 3, 2001), and *Financial Management: Review of Education's Grantback Account* (GAO/AIMD-00-228, August 18, 2000).

² *Major Management Challenges and Program Risks: Department of Education* (GAO-01-245, January 2001) and *High-Risk Series: An Update* (GAO-01-263, January 2001).

³ General controls affect the overall effectiveness and security of computer operations as opposed to being unique to any specific computer application. They include security management; operating procedures; software security features; and physical protection designed to ensure that access to data and programs is appropriately restricted, only authorized changes are made to computer programs, computer security duties are segregated, and backup and recovery plans are adequate to ensure continuity of essential operations.

⁴ Application controls help ensure that transactions completed through computer applications are valid, properly authorized, and completely and accurately processed and reported. Application controls include (1) programmed control techniques, such as automated edits, and (2) manual follow-up of computer-generated reports, such as reviews of reports identifying rejected or unusual items.

As you know, internal controls serve as the first line of defense in safeguarding assets and in preventing and detecting fraud, abuse, and errors. It is incumbent upon Federal agency managers to establish a system of internal control consistent with our *Standards for Internal Control in the Federal Government*.⁵ Given the billions of dollars in payments made by Education each year and the risk of erroneous or fraudulent payments making their way through Education's processes without prevention or detection, you requested that we audit selected Department accounts that may be particularly susceptible to improper payments.

In response to your request, we initiated a body of work designed to (1) identify Education's payment processes, (2) determine what internal controls exist over these processes, (3) assess whether the internal controls provide reasonable assurance that improper payments will not occur or will be detected in the normal course of business, (4) identify additional controls that should be implemented to provide reasonable assurance that improper payments will not occur, and (5) use various computer auditing techniques to identify potentially improper payments made by Education during the period May 1998 through September 2000.

Our review has focused on the \$181.5 billion of disbursements that the Department made from May 1998 through September 2000. This amount includes \$181.4 billion in grant and loan payments processed through Education's Grant Administration and Payment System (GAPS), \$55 million paid by paper checks called third party drafts, and \$22 million in government purchase card purchases. We conducted our work from August 2000 through July 2001, in accordance with generally accepted government auditing standards and investigative standards established by the President's Council on Integrity and Efficiency.

On April 3, 2001, we testified at a hearing held by this subcommittee on our assessment of the internal control over Education's payment processes and the associated risks for improper payments.⁶ Specifically, we described four broad categories of internal control weaknesses (1) poor segregation of duties; (2) lack of supervisory review; (3) inadequate

⁵ *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1), which was prepared to fulfill our statutory requirement under the Federal Managers' Financial Integrity Act, provides an overall framework for establishing and maintaining internal control and for identifying and addressing major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement.

⁶ *Financial Management: Internal Control Weaknesses Leave Department of Education Vulnerable to Improper Payments* (GAO-01-585T, April 3, 2001)

Grant and Loan Payments Lacked Certain Edit Checks and Other Key Controls

audit trails;⁷ and (4) inadequate computer systems' application controls. Following this hearing, the Department established a management improvement team, consisting of eight senior managers, to address the Department's serious management problems.

Since the April 3 hearing, we have focused our work on searching for potentially improper payments resulting from these and one additional internal control weakness we recently identified – transactions that were authorized and executed by persons acting outside the scope of their authority. In my testimony today I will discuss how these weaknesses make Education susceptible to improper payments in each of the major disbursement areas we have reviewed. I will also discuss several confirmed incidence of improper payments identified by our work thus far. Further, I will discuss throughout my testimony the various steps Education has taken to improve the agency's overall control environment and its efforts to research the potentially improper payments that we have identified. I will now provide a summary of our findings thus far in each of the three major disbursement areas.

Education disburses grant and loan payments by electronic funds transfer and processes these payments in GAPS. This disbursement process relies extensively on various computer systems application controls, or edit checks, to help ensure the propriety of these payments. Because these edit checks are important to the Department's controls over grant and loan payments, we focused our work on assessing whether existing edit checks were working effectively and whether additional edit checks and controls are needed.

Using computerized matching techniques, we tested the \$181.4 billion of grant and loan payments processed through GAPS to identify potentially improper payments that could have resulted from either ineffective edit checks or the lack of necessary edit checks. Following are examples of improper and potentially improper payments we identified through our various tests.

⁷ Sound internal controls also include creating and maintaining adequate documentation providing a means to trace transactions back to their origination – in other words, generating “audit trails.” While audit trails are essential to auditors and system evaluators, they are also necessary for day-to-day operation of the system because they allow for the detection and systematic correction of errors that arise. The Joint Financial Management Improvement Program's *Core Financial System Requirements* state that federal financial systems must provide certain crucial audit trails, including trails to identify document input, change, approval, and deletions by the originator.

We found that Education's student aid application processing system lacks an automated edit check that would identify students that were much older than expected. To identify improper payments that may have resulted from the absence of this edit check, we initially identified institutions that disbursed Pell Grants over multiple years to students 70 years of age or older. We chose to test for students of this age because we did not expect large numbers of older students to be enrolled in a degree program and thus eligible for student aid.

Based on the initial results of our test of students 70 years of age or older and because of the problems we identified in the past, we decided to expand our review of schools that had disproportionately high numbers of older students to include recipients 50 years of age or older. Our Office of Special Investigations, in coordination with Education's IG, investigated four schools that disbursed as much as \$3.4 million in Pell Grants to ineligible students. These students were ineligible because their primary course of study was English as a second language, and they were not seeking a degree or determined to need English language instruction in order to utilize their existing knowledge and skills. The investigation disclosed that at least one of the schools generated fraudulent student admissions documents to create the appearance that students who were not in fact seeking a degree were participating in a degree program. We previously investigated two of these four schools in 1993 and found the similar activities, including the falsification of student records to support the schools' eligibility to participate in the Pell Grant program.⁸ We have also identified three other schools that disbursed about \$500,000 in Pell Grants that warrant additional review. These schools have unusually high concentrations of older, foreign-born students who are more likely to be studying English as a second language. We will formally refer the information related to these three schools, as well as the results of our investigations of the four schools discussed above, to Education's IG for appropriate follow-up.

During our testing, we also identified an additional 708 schools that disbursed Pell Grants to students 70 years or older totaling \$4.5 million. We provided lists of these schools to the Department for additional analysis. Based on its analysis, Education has determined that two of these schools also exhibited disbursement patterns similar to the schools above that disbursed Pell Grants to ineligible students for the study of English as a second language. For these two schools, the Department plans to perform full program reviews later this year to assess their

⁸*Student Financial Aid Programs: Pell Grant Program Abuse* (GAO/T-OSI-94-8, October 27, 1993).

eligibility to continue to participate in the Pell Grant program. We are currently expanding our review in this area to determine whether additional schools may be inappropriately disbursing Pell Grants.

Education told us that they have performed ad hoc reviews in the past to identify Pell Grants disbursed to ineligible students and have recovered some improper payments as a result of these reviews. Based on the results of our analyses, Education has decided to implement a new edit check for students' 85 years or older beginning with the 2002–2003 academic year. If the birth date on a student's application indicates the student is 85 years of age or older, the application processing system will identify the applicant and Education will forward the information to the school for follow-up. Education also said it conducts other limited procedures – including the use of Single Audit results – to assess schools' determination of student eligibility. However, these procedures are not specifically designed to identify schools that are knowingly disbursing Pell Grants to students who are not eligible to participate in the program.

Regarding the edit check that Education plans to implement in the 2002 – 2003, we believe the age limit is too high and will exclude many potential problems. Using Education's criteria, we would have identified less than 1 percent of the students that were ineligible to receive as much as \$3.4 million in Pell Grants. Further, given the recurring nature of improper Pell Grant disbursements, we feel it is incumbent upon Education to implement a formal, routine process to identify and investigate questionable disbursement patterns such as those I have discussed.

Another key control, which was not in effect during the time of our review, was a match of student social security numbers (SSN) with Social Security Administration (SSA) death files. As a result, we had SSA compare loan and grant recipient data in Education's systems with SSA's death records. SSA identified over 900 instances, totaling \$2.7 million, in which the student SSN was listed in SSA's death records. We are currently in the process of reviewing additional data from Education that they believe supports the propriety of many of these payments. Beginning with the 2000-2001 award year (subsequent to our review period), as part of the application process, Education started matching student SSNs with SSA death records to identify potentially improper payments.

We also performed several additional tests of Education's existing edit checks to identify potentially improper grant and loan payments that may not have been detected by these checks. These tests included searches for a single SSN associated with two or more dates of birth, grants to recipients in excess of statutory limits, and searches for invalid SSNs.

Third Party Draft Process Lacked Preventive and Detective Controls

Based on these tests, we initially identified \$43.6 million in potentially improper payments, for which Education has to date been able to provide sufficient supporting documentation for \$18.7 million or about 42 percent of these payments.⁹ Education is in the process of researching the remaining \$24.9 million of potentially improper payments. Our conclusion as to the effectiveness of Education's existing edit checks will depend on the resolution of the remaining \$24.9 million currently being researched by the Department.

Education's third party draft¹⁰ system was originally set up to efficiently process checks to pay non-Education employees who review grant applications, known as field readers. However, in May 1999, Education's policy manual expanded the use of third party drafts to pay for other expenses including employee local travel reimbursements, fuel and maintenance for government vehicles, and other small purchases. Third party drafts could be issued for up to \$10,000 - the limitation printed on the face of each draft. Executive Officers¹¹ determine who has signature authority within their units. From May 1998 through September 2000, Education's payments by third party draft totaled \$55 million. During our analysis of the third party draft payment process, we identified several internal control weaknesses, including inadequate computer systems application controls, poor segregation of duties, and inadequate audit trails. Specifically, as we discussed in our April 3, 2001, testimony, Education (1) circumvented a system's application control designed to avoid duplicate payments by adding a suffix to the invoice/voucher number when the system indicates that an invoice/voucher number has already been used; (2) allowed 21 of the 49 Education employees who could issue third party drafts to do so without involving anyone else; and (3) lacked adequate audit trails, such as a trigger log, to identify changes made to the list of approved vendors. Based on these weaknesses and information gathered from Education IG reports, we designed tests to identify potentially improper payments in this area. These tests included various automated searches of Education's disbursement data, as well as manual reviews of about 38,000 third party draft transactions. Based on these analyses thus far, we have identified 268 instances in which multiple third party drafts were issued to the same payee with the

⁹ Many of these potentially improper payments resulted from erroneous data in Education's system that was subsequently corrected.

¹⁰ Third party drafts are a form of payment similar to a personal check.

¹¹ Executive Officers have the day-to-day general responsibility for financial management and maintaining funds control for the programs and activities of each of the major organizational units within Education.

Government Purchase Card Process Lacked Preventive and Detective Controls

same invoice number or on the same day, totaling about \$8.9 million. Education officials are in the process of researching and providing supporting documentation for these transactions, which we will then test for overpayments and duplicate payments.

In addition to analyzing the support for the potentially improper payments I have described, we plan to perform various computerized sorts and searches to identify additional anomalies, including a thorough review of third party drafts issued by individuals with complete control over the payment process to determine whether questionable transactions occurred that require additional research to assess their propriety. Following the April 3, 2001 hearing, Education took action to eliminate the use of third party drafts. The Department's Third Party Draft Program's Closing Procedures, issued in May, 2001, indicates that Treasury payments will replace third party drafts. In addition, Education officials acknowledged that the Department lacks adequate trigger logs and told us that they are currently developing and implementing more-effective trigger logs. Even though Education is no longer issuing third party drafts, this is an important improvement because the same system that produced those payments also produces Treasury payments, which are replacing third party drafts.

Government purchase cards are available to federal agencies under a General Services Administration (GSA) contract and, according to instructions from the Department of Treasury, should generally be used for small purchases up to \$25,000. Treasury requires agencies to establish approved uses and limitations on the types of purchases and dollar amounts. According to a departmental directive, Education's policy is to use government purchase cards for authorized purchases of expendable goods and services, such as supplies not available from the GSA Customer Supply Center. From May 1998 through September 2000, the time frame for our review, Education's payments by government purchase card totaled over \$22 million.

During our analysis of the purchase card payment process, we identified internal control weaknesses, including inadequate computer systems application controls, lack of supervisory review, and improper authorization of transactions. Specifically, we found that Education (1) did not use management reports available from Bank of America, Education's contractor for government purchase cards, to monitor purchases; (2) had serious deficiencies in its process for reviewing and approving purchase card transactions; and (3) allowed employees to execute transactions beyond the scope of their authority. Inadequate control over these expenditures, combined with the inherent risk of fraud

and abuse associated with purchase card purchases, provides Education employees the opportunity to make unauthorized purchases without detection.

Based on these weaknesses and information gathered from Education IG reports, we designed tests to identify potentially improper payments made with government purchase cards. As with third party drafts, we performed various automated searches of purchase card disbursement data. Specifically, we sorted the data by principal office, cardholder, vendor, and Merchant Category Code (MCC)¹² to identify unusual transactions and patterns. We supplemented these computerized searches with manual reviews of the over 35,000 purchase card transactions. We also selected 5 months of cardholders' statements, a total of 903 statements, to review for certain attributes, including approving official's signature.

Out of the 903 purchase cardholders' monthly statements totaling \$4 million that we reviewed, 338 statements, totaling about \$1.8 million, were not properly approved.¹³ Because this key control—supervisory review and approval—was not operating, we requested supporting documentation for these transactions from the Department. Education has provided invoices and other support related to most of the transactions included in these monthly statements. The Department believes this support will validate these transactions. We are currently reviewing the support to confirm this assessment.

We provided Education with an additional 833 transactions, totaling about \$362,000, in which the payee appeared to be an unusual vendor to be engaging in commerce with the Department. For example, we found one instance, that is now being investigated by our Office of Special Investigations, in which a cardholder made several purchases from two pornographic Internet sites. The names of these sites should have aroused suspicions when they appeared on the employee's monthly credit card bill. We also found another instance in which Education paid for an employee to take a training course completely unrelated to activities of the Department. In addition, we gave Education a list of 124 instances,

¹² The MCC relates to the types of supplies or services that a vendor provides. The MCC for the Government Purchase Card consists of 11 retail categories. Agencies have the ability to prohibit cardholders from purchasing certain supplies or services by blocking specific MCCs.

¹³ The Department of Defense (DOD) issued a Fraud Alert in June 2000 indicating that government purchase card use is increasing and that along with the increase in spending levels there has been an increase in card abuse. DOD has identified several instances involving the fraudulent use of government purchase cards, some the result of supervisors who may have been negligent in their review of purchases.

totaling about \$600,000, in which it appears that cardholders may have split their purchases into multiple transactions to bypass pre-established single-purchase spending limits. Education is currently researching these transactions.

In our April 2001 testimony, we also reported that individual cardholders' monthly purchase limits were as high as \$300,000. Education, in response to a letter from this subcommittee dated April 19, 2001, said the Department has taken action to improve internal controls related to the use of the government purchase card. Education has lowered the maximum monthly spending limit to \$30,000, revoked some purchase cards, and lowered other cardholders' single purchase and total monthly purchase limits. While these are important improvements, they will not prevent cardholders from continuing to split large purchases in order to circumvent single purchase limits. In addition, they do not address the issue of lax approval practices.

To address these issues, Education needs to reiterate and strengthen its policy of requiring review and approval of cardholders' monthly statements, including a review for potentially split purchases. In addition, Education should institute a mechanism to periodically monitor purchase card activity to ensure that proper review and approval is occurring and that split purchases are not. Further, since MCCs can be effectively used to prevent purchases from certain types of vendors, Education should expand its list of MCCs that are being blocked to further help prevent improper payments.

Conclusions and Recommendations

In closing, Mr. Chairman, I want to emphasize the importance of Education management's giving top priority to improving internal control to minimize the agency's vulnerability to improper payments. The Secretary's actions to establish a management improvement team to address the Department's serious management problems, and to respond to issues related to using third party drafts and purchase cards, are important first steps. However, there are other important steps that we recommend be taken to address the Department's control problems. The Department needs to (1) establish appropriate edit checks to identify unusual grant and loan disbursement patterns, (2) implement a formal routine process to investigate unusual disbursement patterns identified by the edit checks, (3) reiterate to all employees established policies regarding the appropriate use of purchase cards, (4) strengthen the process of reviewing and approving purchase card transactions, focusing on identifying split purchases and other inappropriate transactions, and (5) expand the use of MCCs to block transactions with certain vendors. Further, the Department needs to continue to focus on researching and

resolving the potential improper payments that we have identified thus far. This will help provide a clear picture of any fraud or abuse that has occurred. Once the improper activities are identified, immediate action can be taken to terminate them. We discussed our recommendations with Department officials and they generally concurred. We may have additional recommendations after we complete our work later this fall.

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

Contact and Acknowledgments

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