

# **Meeting With Representatives of the PA State Auditor General Regarding Performance Audit of Affairs of PHEAA**

Monday, July 30, 2007

Harrisburg, PA

## **Suggested Areas For Audit Emphasis**

### **Overall Mission**

PHEAA's stated mission, and presumably its authorized reason for existence, "is to improve higher education opportunities for Pennsylvanians". Are PHEAA's expanding operations, focus and utilization of resources outside of Pennsylvania consistent with its published Mission Statement and do such activities meet the single objective of the Mission Statement?

### **Effectiveness of Corporate Governance**

Newspapers have reported profligate spending authorized by executives of PHEAA on retreats, conferences, seminars, and travel and entertainment over a period of years involving PHEAA's board of directors (the "Board"). PHEAA's Board is controlled by PA state legislators. Over the approximately five-year period 2002- 2006, what oversight of such activities did the Board exercise and have adequate policies now been put in place to safeguard the public's money and prohibit the recurrence of such spending.

### **PHEAA's Tax Exempt Status**

PHEAA and its affiliates are exempt from federal and state income taxes under certain provisions of the Internal Revenue Code. Such exemption from taxation represents a substantial subsidy to PHEAA by taxpayers. Does PHEAA's expanded and increasingly diversified operations and substantial profitability (Operating Income of \$155.5 million and \$149.0 million for the two fiscal years ended June 30, 2006 and 2005, respectively) jeopardize PHEAA's qualifications for exemption from taxation on income?

### **Unethical Student Lending Practices**

Has PHEAA engaged in any of the "Unethical Student Lending Practices" recently publicized and described in the following summary published by the Committee on Education and Labor of the United States House of Representatives?

Are sufficient internal controls in place and operating effectively so as to insure the integrity of all of the Agency's operations?

### **Authorized Programs**

Are programs such as "Quality Early Education Loan Forgiveness" and "Hurricane Katrina Emergency Grant Assistance", regardless of how worthwhile such programs may be and how effectively they are operated, consistent with PHEAA's stated mission of "Improv(ing) higher education opportunities for Pennsylvanians"? Is the loan forgiveness under the Armed Forces Loan Forgiveness" program limited to residents of and/or students attending Pennsylvania colleges and universities?

Are the growing number and diversified nature of PHEAA's numerous programs an efficient use of public monies to further the Agency's principal mission objective?

### **Loan and Grant Conflicts**

Are policies and internal controls in effect that preclude any Agency financial transactions (grants, loans, guaranties, etc.) from benefiting, directly or indirectly, any members of executive management, the board of directors, or other elected state legislators or elected or appointed state officials?

### **Financial Derivatives, Interest Rate Swaps, Counter-Party Fees and Risk**

Are the transactions described in Note 9 to PHEAA's June 30, 2006 financial statements financially prudent and necessary in relation to the cost and exposure to risk inherent in such complex and esoteric arrangements? Would PHEAA be financially better off if it did not engage in such transactions?

PHEAA's financial statements indicate that it enters into hedging transactions to mitigate certain financial risks. Over the last few months, several quasi-government mortgage funding organizations have had to restate financial statements in part because of what appears to have been the inappropriate shifting from legitimate hedging to inappropriate speculation. From an operations point of view, while the accounting ramifications may not be paramount, the controls over this entire hedging activity are paramount. Are there written policies and procedures in place to ensure effective oversight of this activity and are decisions made at a high enough level to ensure speculation is avoided?

In connection with the above, the last sentence of the aforementioned Note 9 seems to indicate some ease in terminating hedging contracts. What controls

exist to ensure legitimate hedging hasn't been converted to speculation through contract terminations?

### **Business Purpose and Justification For Related Foundations**

PHEAA has recently established three "charitable-purpose" foundations as described in Note 1 to its June 30, 2006 financial statements. The affiliated foundations are:

1. The Pennsylvania Higher Education Foundation, Inc. ("PHEF")
2. PHEAA Student Loan Foundation, Inc.
3. Higher Education Foundation, Inc. ("HEF")

All three foundations are claimed to be exempt from taxation under Section 501 (c) (3) of the Internal Revenue Code as organizations having charitable purposes. The purposes described for these three related-party organizations are as follows:

PHEF – formed on June 22, 2001 to create the Nursing Education Grant Program and to engage in activities intended to improve or enhance post-secondary education opportunities for students in Pennsylvania and elsewhere.

PHEAA Student Loan Foundation, Inc. - formed on August 6, 2002 to carry out student loan securitization transactions for PHEAA's benefit.

HEF - formed on June 22, 2001. Its charitable purpose is exclusively for the benefit of PHEF and the directors of HEF are the same as the directors of PHEF. HEF was formed to assist with fundraising and program administration, particularly for projects that may extend beyond Pennsylvania.

PHEF's and HEF's financial statements are not consolidated with PHEAA's financial statements. The PHEAA Student Loan Foundation, Inc. is treated as a component unit of PHEAA and its financial statements are consolidated with PHEAA's financial statements. HEF's financial statements are consolidated with PHEF's financial statements.

We recommend that the Auditor General review the business purpose for the formation and existence of these affiliated foundations. Specifically, what rationale was provided to the Board as justification for establishing these entities?

Additionally we strongly recommend that expenses incurred by the foundations be examined for propriety. Particularly expenses incurred by or initiated by PHEAA and paid for by or charged to the foundations. The President and CEO of PHEF is Michael H. Herschok, the former CEO of PHEAA. He is believed to have an annual compensation from PHEF in the range of \$150,000, plus fringe benefits, including provision for pension benefits.

The Auditor General should ensure that these foundations are not de facto conduits established to provide compensation and benefits to Mr. Hershock and possibly fees and benefits to others. Do they pass the prudent investor rule insofar as utilization of PHEAA's public monies is concerned? From the perspective of outsiders, we see no reason that the functions described as being performed by these foundations, cannot be performed by PHEAA.

**Aggregate Annual Cost of Certain Payments and Relationship Thereof to Political Contributions and Perks For Lawmakers and/or Elected Officials**

In connection with the Auditor General's performance audit of PHEAA's affairs, we highly recommend that one of the principal focal points of such audit be the nature and amount of all professional/consultant-type fees paid to lawyers, including bond counsels, investments bankers or advisers, brokers, accountants, public relations firms, lobbyists and any and all other "service and/or consultant"-type fees, with a particular view to ascertaining the necessity of and value received for such fees [particularly payments made pursuant to no-bid contracts] and the direct or indirect relationship, if any, of such payments with current or former members of Pennsylvania's Legislature (or other elected officials) and current and/or former members of PHEAA's executive management and Board of Director members.

We believe that the aggregate annual amount of such payments will be an eye-opening amount and an amount far in excess of what a private industry firm conducting a similar business would expend for any necessary services.

It has been publicly reported that PHEAA spends approximately \$1 million per year for fees to lobbyists, notwithstanding the fact that 16 of the 20 PHEAA Board members are members of PA's Legislature. With such a notional, high-powered Board, PHEAA should have little need for lobbyists to fulfill its principal mission-statement goal.

It has also been reported that PHEAA recently paid over \$400,000 of legal fees to attempt to withhold public documents paid for with public funds. According to the published account, a portion of the legal fees were paid to the law firm of Stevens & Lee ("S & L"). It is our understanding that PHEAA's Executive Director, Richard Willey was formerly a senior lobbyist with Stevens & Lee from 1993 - 2002. We also believe that legal fees charged by these two firms (S & L and Lamb McErlane) ranged as high as \$330 to \$500 per hour. We have been advised that competent legal services of the type utilized by PHEAA for the subject litigation, can be obtained from Harrisburg-based firms for hourly rates for Partners in such firms in the range of \$200-\$250.

We recommend that one of the principal focuses of your audit be to see if political contributions have been (are being) made by these two law firms to legislator/board of director members of PHEAA or to other PA elected officials.

**The foregoing suggested areas of audit emphasis are recommended in the spirit of best business practices and integrity in our state government and its institutions.**

**If we can be of further assistance to the Auditor General and its staff, we would be pleased to hear from you.**

**Ken Schaefer  
Chairman  
Vote For Integrity**