5.a

Action Item

California Student Aid Commission

Consideration of EDFUND Internal Audit Plan for Fiscal Years 2007-08 and 2008-09

The EDFUND Internal Audit Plan for the two year audit cycle covering FY 07-08 and 08-09 was approved by the Commission and EDFUND Audit Committees on November 8, 2007 and the EDFUND Board on November 16, 2007. The Commission Audit Committee is recommending that the Commission approve the Plan.

Responsible Party: Dean Johnston, Chair
Audit Committee

Internal Audit Plan For the Two Year Audit Cycle (Fiscal Years 07-08 and 08-09)

For Approval by the EDFUND and Commission Audit Committees On November 8, 2007

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Executive Summary

The Internal Audit Department of the Audit Services Division has developed a proposed audit plan, as required by the California Student Aid Commission, EDFUND *Internal Audit Services Charter* and the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing.*

This plan covers the two year period from October 1, 2007 through September 30, 2009. It is the intention of Internal Audit to develop a formal audit plan every two years, with the next plan scheduled to be developed in October 2009. Internal Audit will re-evaluate the plan at the end of the current fiscal year to determine if significant changes in policies, procedures and/or business activities have occurred and modify the plan, if needed. The revised plan will then be presented to the Audit Committees for approval.

The audits included in the audit plan are those of the highest risk that could be covered with existing internal audit resources. Actual audit scheduling may be affected by personnel turnover, unanticipated high priority audit requests and special projects from the Board and/or Executive Management, as well as unforeseen circumstances in a scheduled audit. Audits that cannot be completed with current audit capacity result in an assumption of risk by EDFUND.

The remainder of this document provides our planned audit activities for the two year audit cycle ending September 30, 2009 and allocation of internal audit resources.

High Risk and Required Audits by Fiscal Year

The chart below identifies the areas that will be audited during each fiscal year of the two year audit cycle ending September 30, 2009. A brief description of each audit is provided in the section that follows.

High Risk and Required Audits		
High Risk Audits	**2007 - 08**	**2008 - 09**
DataMart Management and Reconciliation	X	
Default and Specialty Claims Adjudication		X
Default Aversion Assistance	X	
Default Fee		X
External Collections		X
Incident Response and Escalation	X	
Information Security Program		X
Internal Collections	~~X~~	X
Loan Guarantee Process	X	
Manual Borrower and Loan Updates		X
Procurement and Disbursements	X	
Table Maintenance		X
Technology Project Management		X
Wage Garnishments and Tax Offsets	X	~~X~~
Required Audits	**2007 - 08**	**2008 - 09**
Policy 009 Compliance – *Employment of Applicants and Employees with Guaranteed Student Loans*	X	X
Quarterly Review of Transactions on Employee FFEL Loans	X	X
Carry Forward High Risk Audits from FY 2006-07	**2007 - 08**	**2008 - 09**
User Access	X	
Collection Cost Recovery	X	

Planned Internal Audit Activities

The following describes the audit activities planned for the two year audit cycle ending September 30, 2009:

HIGH RISK AUDITS

DataMart Management and Reconciliation (500 staff hours) – A review of the process for transferring and reconciling data from FAPS to the DataMart. This review will also evaluate the uses of the DataMart information for appropriateness.

Default and Specialty Claims Adjudication (500 staff hours) - A review of the processing of defaulted and specialty claims for compliance with regulations and applicable procedures.

Default Aversion Assistance (500~~50~~ staff hours) – A review of the key default aversion assistance activities performed by EDFUND resulting from requests received from lender and servicers. This review also includes a review of the activities performed by EDFUND staff in overseeing the contracted external default prevention servicers.

Default Fee (6~~5~~00 staff hours) – A review of the processes for receiving, tracking, reconciling and reporting default fees assessed to borrowers and/or paid on behalf of borrowers. Additionally, Internal Audit will review the processes for reimbursing lenders and compliance with the terms of the Memorandums of Understanding between EDFUND and the lenders.

External Collections (500 staff hours) – A review of processes for assigning and recalling accounts from third-party collection agencies, overseeing/reviewing the activities of the external collection agencies for compliance with contract terms and calculating commission payments.

Incident Response and Escalation (700 staff hours) – A review of the processes for reporting, tracking, escalating and resolving operational and security related incidents. This review will also evaluate compliance with the response times and escalation requirements defined in Service Level Agreements.

Information Security Program (7~~6~~00 staff hours) – A review of the processes performed by the Security Office to ensure compliance with security policies and standards as well as their monitoring of EDFUND's computer controls related to the protection of sensitive financial and borrower information used in day to day operations.

Internal Collections (500 staff hours) – A review of the key internal collection processes including assigning accounts to collectors, performing borrower contact activities, billing and monitoring of payment plans, notifying credit bureaus and calculating commission payments.

Loan Guarantee Process (50~~5~~0 staff hours) – A review of the processes for receiving, approving, and processing loan guarantee applications received from lenders/servicers and borrowers.

Manual Borrower and Loan Updates (500 staff hours) – A review the processes for performing borrower and loan updates to FAPS for timeliness and accuracy along with proper notifications to lenders/servicers and schools.

Procurement and Disbursements (500 staff hours) – A review of the procurement and disbursement processes to determine if funds disbursed were for authorized purposes, made in accordance with applicable policies and procedures, properly supported and accurately recorded.

Table Maintenance (400 staff hours) – A review of table maintenance changes for proper authorization and adequate supporting documentation in addition to a review of the audit trail functionality and usage. This review will also include a review of the appropriateness of update access to FAPS tables based on job responsibilities.

Technology Project Management (600 staff hours) – A review of the methodologies, policies, standards and procedures for testing and managing technology projects. These projects include internally developed software, web based products and third party software packages.

Wage Garnishments and Tax Offsets (6~~7~~00 staff hours) – A review of the processes for determining borrower qualification for wage garnishment or tax refund offset, notifying credit reporting agencies, and handling borrower appeals.

REQUIRED AUDITS

Policy 009 Compliance – *Employment of Applicants and Employees with Guaranteed Student Loans* (50 staff hours annually) – Annual review of compliance with key internal controls existing at the time a candidate is being considered for employment and throughout an individual's ongoing employment with EDFUND.

Quarterly Review of Transactions on Employee FFEL Loans (100 staff hours annually) – Internal Audit performs this review each quarter. This review stems from a BSA compliance audit finding which stated the need for additional controls to prevent employees from modifying or deleting their own loan records. Management's response to this finding stated that Internal Audit would periodically sample and review system activity on loans associated with EDFUND employees.

CARRY FORWARD AUDITS

This category is dependent upon current audits and projects that are incomplete at the end of the prior fiscal year. For the fiscal year ended September 30, 2007, the following carry forward efforts are currently being worked on:

Collection Cost Recovery (50 staff hours) – This is a review of EDFUND's collection cost rate calculations and how collection costs are applied against borrowers' loans. Internal Audit recently received management's proposed revisions to the report as well as the responses to the audit recommendations and is in the process of finalizing the audit report.

User Access (330 staff hours) – This is a review of the processes for requesting, approving and deleting personnel access to information systems as well as an evaluation of the appropriateness of user access based on job responsibilities. Internal Audit is currently finalizing the test work and drafting the audit report.

FOLLOW-UP ACTIVITIES

Internal Audit performs follow-up audit activities to evaluate management's progress towards implementing the recommended actions identified as part of previously issued internal audit reports. The status of each recommended action is determined based on discussions with key personnel, observing procedures performed, and/or reviewing supporting documentation (540 staff hours for Fiscal Year 2007-08 and 480 staff hours for Fiscal Year 2008-09).

SPECIAL PROJECTS

Time allotted for high priority but unanticipated special assignments requested by the Audit Committees, the Board of Directors, Executive Management and/or Audit Management. A special project to review compliance with Policy #039 *FFEL Program Code of Conduct* is scheduled for Fiscal Year 2007-08. (250 staff hours for Fiscal Year 2007-08 and 285 staff hours for Fiscal Year 2008-09).

OTHER AUDIT RELATED RESPONSIBILITIES

Audit Plan and Risk Assessment (500 staff, AVP and VP hours for Fiscal Year 2007-08 and 2008-09) – Development of this Audit Plan and Risk Assessment for the Fiscal Year 2007-08 and 2008-09. The plan and risk assessment help identify the highest risk areas from an audit standpoint and assists in determining how to deploy internal audit staff for the next two years. Internal Audit will re-evaluate the plan at the end of the current fiscal year to determine if significant changes in policies, procedures and/or business activities have occurred and modify the plan, if needed. Additionally, Internal Audit will begin development of the Audit Plan and Risk Assessment for Fiscal Year 2009-10 and 2010-11 during the last quarter of FY 2008-09.

Internal Projects (475 staff and 250 AVP/VP hours for Fiscal Year 2007-08; 150 staff hours and 50 AVP/VP hours for Fiscal Year 2008-09) – Time allotted to document and implement additional internal audit processes, procedures and tools in preparation for an external quality assurance review. The Institute of Internal Auditors' (IIA) requires that an external assessment be conducted at least once every five years to ensure compliance with internal audit standards. Internal Audit intends to perform a full scope self assessment during the last quarter of fiscal year 2007-08 and anticipates engaging the services of an independent reviewer shortly thereafter to conduct an independent validation of the self assessment. During FY 2008-09 (and in each subsequent year until the next external assessment), Internal Audit will perform a limited scope internal assessment as part of its ongoing internal monitoring process.

External Audits (400 VP hours for Fiscal Years 2007-08 and 2008-09) – Internal Audit is responsible for the co-ordination and issue resolution of all external audits including those performed by Perry-Smith, the Bureau of State Audits (BSA) and the U.S. Department of Education.

NOTE:

The duration of each audit activity is an estimate which may vary due to the scope and objectives that will be determined during the initial planning process of the effort. Unanticipated issues that arise may also vary the duration of each audit or project. Special projects or requests from the Audit Committees, the Board of Directors, and/or Executive Management are considered a priority and may also alter the completion of the audit plan as scheduled.

Allocation of Audit Resources

The approach to developing an annual audit plan recognizes that resources of personnel and dollars are limited which prohibits one hundred percent audit coverage each year. This limiting factor is inherent in the concept of utilizing a risk assessment to help prioritize audits.

The estimated number of available staff and management hours to conduct internal audit activities is presented below.

	Fiscal Year	
Internal Audits	**2007-08**	**2008-09**
High Risk	3,300	4,300
Required	150	150
Carry Forward	380	-
Follow-up Activities	540	480
Special Projects	250	285
Management Review and Oversight	1,364	1,429
Subtotal	5,984	6,644
Other Audit Related Responsibilities		
Audit Plan and Risk Assessment	500	500
Internal Projects	725	200
External Audits (co-ordination and issue resolution)	400	400
Subtotal	1,625	1,100
Non-Audit		
Continuing Education	360	360
Leave (personal time and holidays)	1,944	1,680
Staff/Leadership Meetings and Other Administrative Responsibilities	2,808	2,808
Subtotal	5,112	4,848
Total hours	**12,721**	**12,592**

5.b

Action Item

California Student Aid Commission

Acceptance of Operating Fund and Federal Fund Audited Financial Statements for the Years Ending June 30, 2007 and 2006

Perry-Smith LLP presented their independent audit of the Operating Fund and Federal Fund financial statements for the year ended June 30, 2007 to the Commission and EDFUND Audit Committees at their September 26, 2007 joint meeting. The Committees formally accepted the audited financial statements during the meeting and the EDFUND Board did the same at their November 16, 2007 meeting. The Commission Audit Committee is recommending acceptance by the Commission.

Responsible Party: Dean Johnston, Chair
Audit Committee

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

FINANCIAL STATEMENTS

FOR THE YEARS ENDED JUNE 30, 2007 AND 2006

AND

INDEPENDENT AUDITOR'S REPORT

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

FINANCIAL STATEMENTS

For the Years Ended June 30, 2007 and 2006

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PERRY-SMITH LLP
ACCOUNTANTS

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INDEPENDENT AUDITOR'S REPORT

The Honorable Members
California Student Aid Commission
Rancho Cordova, California

We have audited the accompanying financial statements of the Student Loan Operating Fund (Operating Fund) and Federal Student Loan Reserve Fund (Federal Fund) of the California Student Aid Commission (the "Commission") as of and for the years ended June 30, 2007 and 2006, as shown in the accompanying table of contents. These financial statements are the responsibility of the Commission's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Commission's Operating and Federal Funds' internal control over financial reporting. Accordingly, we express no such opinion. 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.

As discussed in Note 1, the financial statements present only the Operating Fund and Federal Fund of the Loan Program of the Commission and do not purport to, and do not, present fairly the financial position of the California Student Aid Commission as of June 30, 2007 and 2006, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial positions of the Operating Fund and Federal Fund of the California Student Aid Commission as of June 30, 2007 and 2006, and their changes in financial position and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

PERRY-SMITH LLP
ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT
(Continued)

The accompanying management's discussion and analysis on pages 3 through 10 is not a required part of the financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 26, 2007 on our consideration of the Operating Fund's and Federal Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Perry-Smith LLP

Sacramento, California
September 26, 2007

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following Management's Discussion and Analysis (MD&A) of the California Student Aid Commission's (Commission) Federal Family Education Loan (FFEL) Program activities and performance provides the reader with an introduction and overview of the financial performance of the Student Loan Operating Fund (Operating Fund) and the Federal Student Loan Reserve Fund (Federal Fund) during fiscal years ended June 30, 2007, 2006 and 2005. The information contained in this MD&A should be read in conjunction with the financial statements following this section.

This report consists of four parts: *The Independent Auditor's Report, Management's Discussion and Analysis* (this section), *Basic Financial Statements* (Balance Sheets, Statements of Revenues, Expenses, and Changes in Net Assets, and Statements of Cash Flows), and the *Notes to the Financial Statements*, which explain in further detail information contained in the financial statements.

The Commission is responsible for both loan and grant programs. The loan program consists of activities related to the Commission's responsibility as a designated guarantor for the FFEL Program. The FFEL Program allows undergraduate or graduate students at eligible postsecondary schools to obtain federally guaranteed loans from private lenders at advantageous interest rates. The grant program encompasses all activities related to the Commission's administration of the state Cal Grant and specialized programs. The accompanying financial statements present the financial position of the Operating and Federal Funds only and do not present the financial position or results of operations of any other Commission fund.

Financial Highlights

The Commission administers the FFEL program in conjunction with its auxiliary organization, EDFUND. During 2006-07 the program faced several changes resulting from the passage of the Higher Education Reconciliation Act (HERA) including a new federal requirement that all guaranty agencies deposit a Federal Default Fee (FDF) to their Federal Fund equal to 1 percent of the disbursement amount for loans guaranteed on and after July 1, 2006. Honoring a long-standing commitment to borrowers, the Commission continued waiving this fee through September 30, 2006 at a cost of $25.5 million to the Operating Fund. This fee waiver exemplifies EDFUND's continued commitment of being the premier service provider in the student loan industry and to maintain and grow market share. As a result, the total number of scholastic institutions served increased by 4 percent through the addition of 70 new colleges and universities over the course of 2006-07, while 272 new schools were added in 2005-06.

Loan guarantees in 2006-07, excluding consolidations, were $6.7 billion compared with a similar $6.7 billion guaranteed in 2005-06. Additionally, annual consolidation loan guarantees grew $2.9 billion compared with the $2.7 billion processed in 2005-06 for a 7.4 percent increase. This change reflects management's focus towards the end of 2005-06 to capitalize on regulatory changes to grow the outstanding portfolio through consolidation initiatives. Additionally, investments in borrower benefits are more crucial than ever to attract and retain new loan volume. As such, waiving the FDF helped maintain market share and saved borrowers a total of $25.5 million in 2006-07, compared to $50 million in 2005-06, resulting in cumulative savings to borrowers of approximately $322.5 million since insurance premiums (the FDF predecessor) were first waived in 1996-97.

The Commission remitted $173.8 million to the U.S. Department of Education (ED) in 2006-07 for the federal share of defaulted loans recovered, a 143 percent increase from the $71.5 million remitted in the previous fiscal year. This change reflects the ongoing success of initiatives implemented in 2005-06 focusing collection efforts on rehabilitation loan recoveries instead of federal direct loan consolidation recoveries. This strategy shift positions the Commission to easily meet the requirement under the HERA that caps income from federal direct loan consolidation recoveries at 45 percent of annual defaulted loan collections beginning in 2009. The initiative also positions the Commission to capitalize on federal regulation effective July 1, 2006 which allows for defaulted loans to be rehabilitated with 9 on-time payments in a 10-month period instead of the previously required 12 monthly payments.

MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)

The Commission, through the performance based features of the Voluntary Flexible Agreement (VFA), received $7.7 million in 2006-07 solely from Early Withdrawal Fee funding generated from borrower default prevention counseling efforts. While this fee funding is comparable with the $7.8 million generated in 2005-06, the Operating Fund did not qualify for shared claims savings or performance based collections in 2006-07 which generated $14.2 million and $13.8 million in 2005-06, respectively.

In addition to supporting the Commission's guaranty agency responsibilities, the Operating Fund has been used since 2003-04 to fund the Commission's outreach and grant programs as follows:

- $14.4 million and $11.5 million during 2006-07 and 2005-06, respectively, for the administration of the Commission's grant and specialized programs.
- $12.1 million and $16.7 million during 2006-07 and 2005-06, respectively, in Financial Aid Awareness programs. Of these amounts, $8.6 million and $8.5 for the California Student Opportunity and Access Program (Cal-SOAP) for fiscal years 2006-07 and 2005-06, respectively, to provide financial aid outreach and tutoring services to disadvantaged students.
- $51 million in 2005-06 remitted to the State of California's General Fund to support the Cal Grant Awards program. These grants are awarded to students to help pay for college expenses. No remittance to the State was required for 2006-07.

Program Overview

The loan program consists of two funds: the Operating and Federal Funds (Funds). The Operating Fund is agency-owned and managed, while the Federal Fund is the property of the United States government and is regulated by the Secretary of Education.

The Operating Fund, a state fund within the custody and control of the Commission, reflects transactions related to guarantor activities as specified by law. These activities include loan origination and guaranty processing, default aversion and default collection. The Operating Fund also reflects other student financial aid related activities as selected by the guaranty agency, including activity related to the administration of the state Cal Grant and specialized programs.

Operating Fund revenues are derived principally from collections on defaulted student loans and performance based fees paid by ED. The Federal Fund, whose assets are the property of ED, largely reflects transactions related to the Commission's student loan insurance activity. These transactions include payments to lenders for defaulted claims along with certain administrative fees paid to the Operating Fund. Federal Fund revenues are recognized primarily from the federal default fee and claim purchase complement from collection recoveries.

The Operating Fund and Federal Fund follow accounting for business-type activities using the flow of economic resources measurement focus and accrual basis of accounting. Accordingly, revenues are recognized when earned and expenses are recognized when the liability is incurred regardless of the timing of the related cash flow. The most significant example is the allowance for the Default Aversion Fee (DAF). Upon fee billing, an estimated refund liability is recorded in the Operating Fund and a corresponding receivable in the Federal Fund. These entries recognize the long-term obligation to refund the fee if the loan subsequently defaults triggering fee repayment.

MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)

Net recoveries on loan defaults are deposited in the Operating Fund. After a loan defaults, the Commission continues its collection efforts and is allowed to retain as revenue to the Operating Fund up to 23 percent of the amount collected. For loans that have been rehabilitated (effective July 1, 2006, 9 on-time payments in a 10-month period; previously, 12 consecutive monthly payments made by the defaulted borrower) or consolidated out of default by a third-party refinancing, the Commission is allowed by federal regulation to retain a percentage of the total amount received relating to the retirement of the post-default obligation. The remaining amounts are returned to the federal government.

The 1998 Reauthorization of the Higher Education Act (1998 Amendments) established that certain fees would be paid to the Operating Fund for administering the loan program on behalf of the federal government based on guaranty agency performance. Administrative and program fee income are known as the Default Aversion Fee (DAF), the Loan Processing and Issuance Fees (LPIF), and the Account Maintenance Fee (AMF).

Administrative and program fees from the federal government for guaranty activities are deposited in the Operating Fund. The LPIF is calculated at a rate of 0.40 percent of disbursed dollars from new loan guarantee volume. The AMF is calculated at 0.10 percent of the original principal outstanding portfolio (OPO) balance (which includes the cumulative guarantee volume less cumulative cancellations, claims paid, and loans paid in full) at federal year end. Due to HERA changes, this fee was paid entirely by ED in 2006-07. In prior years, AMF was paid predominantly from ED, but a portion was transferred from the Federal Fund as required by regulation in the form of AMF subsidy.

The Operating Fund also receives DAF revenue, which is paid as an incentive to prevent loan defaults. These fees are paid from the Federal Fund directly to the Operating Fund based on the dollar amount of first-time default aversion assistance requests multiplied by 1 percent. Should the loan subsequently default, the DAF must be repaid based on 1 percent of the claim amount.

The Voluntary Flexible Agreement (VFA) is a pilot program allowing selected guaranty agencies to negotiate alternative fee structures. These changes must be cost-neutral and show no overall increase in total costs to the FFEL Program. VFA income is revenue to the Operating Fund. The Commission negotiated the following three revenue sources as part of its VFA:

- Shared claim savings
- Early withdrawal fee
- Performance based collections

Shared claim savings are paid by the federal government based on the dollar amount of reinsurance claims paid below a 3 percent default trigger rate. The early withdrawal fee (WAF) is paid for counseling borrowers who withdraw early from school. Similar to DAF, the WAF is paid from the Federal Fund to the Operating Fund and must be repaid if the loan defaults in the future. However, loans paid a WAF are not eligible to receive a DAF. Performance based collections revenue is based on two conditions. First, the collection recovery rate must be greater than that established in 1999-00. Second, the Commission's collection recovery rate must be greater than the national average. If these two conditions are met, the federal government will increase collection retention by each basis point above the hurdle rate established in fiscal year 1999-00. At ED's request, EDFUND on behalf of the Commission, submitted a revised VFA proposal to renegotiate the terms of the current VFA. Specific agreement changes and effective dates have not yet been agreed upon and the status of ED's proposal evaluation is unclear. However, the current VFA is still in place.

MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)

During 2006-07, a new lender premium fee revenue source was added to the Operating Fund. The fee is determined through a contractual relationship with a lending partner and is based on a scaled premium paid by the lender when purchasing loans qualifying for rehabilitation. Criteria for compensation include the total loan amount (principal, interest and collection costs).

In 2004-05 and 2005-06, the minimum reserve subsidy, funded from the Operating Fund, was needed to supplement Federal Fund revenues to ensure the federally mandated minimum reserve requirement was maintained. After the first quarter of 2006-07, this subsidy was discontinued as the Federal Fund was able to maintain its required minimum reserve level independently due to the mandatory depositing of the federal default fee as required by the HERA.

The Commission's primary function as a guarantor is to guarantee the outstanding principal and interest due to the lenders when a borrower fails to bring their loan back to a current repayment status within the regulatory required timeframe. Under federal regulations, the Commission is required to maintain a minimum balance in its Federal Fund to purchase loans from lenders when all default aversion efforts fail to return delinquent borrowers to a current repayment status. Lenders are currently paid an amount representing 97 percent of principal and calculated interest. The federal government then reimburses the Federal Fund a percentage of the default claims paid to the lender based on the loan guarantee date as follows:

- Loans guaranteed before October 1, 1993 — 100 percent
- Loans guaranteed between October 1, 1993 - September 30, 1998 — 98 percent
- Loans guaranteed on or after October 1, 1998 — 95 percent

Effective January 2004, qualified lenders designated for exceptional performance (EP) received 100 percent reimbursement on claims submitted for insurance during the 12-month period following the date the lender and its guarantors receive notification. This reimbursement rate dropped to 99 percent beginning July 1, 2006 and pending federal legislation proposes to eliminate lender EP status entirely this upcoming year once the bill, already passed by Congress, is signed by the President. The Commission currently has 15 lenders participating in the EP program.

The FDF is the primary source of revenue to the Federal Fund. As previously stated, this fee replaced the insurance premium and is based on 1 percent of the loan disbursement amount for loans guaranteed on or after July 1, 2006.

In 2006-07, claim purchase complement revenues increased significantly in the Federal Fund due to the associated shift in collection strategy on defaulted loans away from federal direct loan consolidations to rehabilitation loan recoveries. For each collection payment received, the Commission is required to deposit into the Federal Fund an amount equal to the payment multiplied by the reinsurance rate complement. The reinsurance complement is either 2 percent or 5 percent, depending on the year the loan was guaranteed. However, federal direct consolidation recoveries require no complement revenue to the Federal Fund.

MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)

Overview of the Financial Statements

The following table provides a summary of the balance sheets and revenues, expenses, and changes in net assets for both the Operating Fund and Federal Fund as of and for the fiscal years ended June 30, 2007, 2006 and 2005.

	Operating Fund *Amounts in thousands*			Federal Fund *Amounts in thousands*		
Summary of Balance Sheets	**2007**	**2006**	**2005**	**2007**	**2006**	**2005**
Current assets	$ 31,034	63,082	105,039	102,622	97,477	99,543
Other noncurrent assets	20,295	20,239	20,000	—	—	—
Total assets	51,329	83,321	125,039	102,622	97,477	99,543
Current liabilities	27,322	58,291	13,755	31,325	32,125	34,844
Noncurrent liabilities	—	—	—	—	8,208	16,415
Total liabilities	27,322	58,291	13,755	31,325	40,333	51,259
Net assets:						
Restricted	—	—	—	71,297	57,144	48,284
Unrestricted	24,007	25,030	111,284	—	—	—
Total net assets	$ 24,007	25,030	111,284	71,297	57,144	48,284

	Operating Fund *Amounts in thousands*			Federal Fund *Amounts in thousands*		
Summary of Revenues, Expenses and Changes in Net Assets	**2007**	**2006**	**2005**	**2007**	**2006**	**2005**
Operating revenues:						
Net recoveries on loan defaults	$ 73,514	53,083	60,748	—	—	—
Administrative and program fee income	63,777	58,420	42,722	—	—	—
VFA revenue	7,736	35,740	62,617	—	—	—
Lender premium fees	1,323	—	—	—	—	—
Federal default fee	—	—	—	47,238	—	—
Minimum reserve subsidy	—	—	—	9,392	69,089	27,537
Claim purchase complement	—	—	—	7,767	3,055	1,904
Other	607	94	71	720	25	63
Operating revenues	146,957	147,337	166,158	65,117	72,169	29,504
Operating expenses:						
Administrative	88,252	87,740	102,869	—	—	—
Minimum reserve subsidy	9,392	69,089	27,537	—	—	—
Fee subsidies	25,513	—	—	20,932	17,773	8,258
Loan default expense	—	—	—	28,556	21,452	16,726
Other	—	—	—	2,691	24,730	3,630
Operating expenses	123,157	156,829	130,406	52,179	63,955	28,614
Nonoperating revenues (expenses)						
Interest income	1,691	2,442	2,698	1,215	646	547
Cal Grant program awards	—	(51,000)	(146,500)	—	—	—
Grant administrative costs	(14,404)	(11,502)	(11,231)	—	—	—
Financial aid awareness program	(12,110)	(16,702)	—	—	—	—
	(24,823)	(76,762)	(155,033)	1,215	646	547
Change in net assets	$ (1,023)	(86,254)	(119,281)	14,153	8,860	1,437

Financial Analysis of the Operating Fund

At fiscal year ended June 30, 2007, total net assets of the Operating Fund reflect a decrease from the prior year of $1.0 million to $24.0 million compared to a $86.3 million decrease to $25.0 million at June 30, 2006. Net assets are composed entirely of unrestricted net assets. This net asset change is primarily due to the items noted below.

- In fiscal year 2007, total operating and nonoperating revenues remained fairly consistent decreasing by $1.1 million (less than 1 percent from 2006) to $148.6 million; however, the mix of revenue sources changed notably.
- Net recoveries on loan defaults increased significantly to $73.5 million in 2006-07 from $53.1 million in 2005-06. This increase reflects the change in management's collection strategy shifting collection efforts from consolidation loans to rehabilitation loan recoveries. Rehabilitation loans enable borrowers to improve their credit rating while bringing their student loan balances out of default status, and provide increased revenues to the Operating Fund because of higher retention rates on this collection type.
- Administrative and program fee income also increased to $63.8 million in 2006-07 from $58.4 million in 2005-06. This increase is in AMF as OPO increased by approximately 8 percent, and in DAF due to an increasing rate of default aversion assistance requests for consolidation and proprietary loan borrowers. For the first quarter only of 2004-05, the Federal Fund waived funding and the Operating Fund waived recording the DAF revenue to assist the Federal Fund in maintaining its required minimum reserve level.
- Lender premium fee was established in 2006-07 and provided $1.3 million in revenues to the Operating Fund.
- Administrative operating expenses decreased $0.5 million, or less than 1.0 percent, for the year ended June 30, 2007 due to management's continued emphasis on realizing operating efficiencies. Similar improvements were noted as of June 30, 2006 as expenses decreased $24.6 million, or 23.9 percent, from the prior year.
- The federal default fee subsidy was established in 2006-07 and funded $25.5 million from the Operating Fund to the Federal Fund on the behalf of student borrowers.
- Minimum reserve subsidy decreased to $9.4 million for the year ended June 30, 2007 from $69.1 million for the year ended June 30, 2006. This decrease results from the Federal Fund's ability to independently maintain its required minimum reserve level from federal default fee and claim purchase complement revenues.
- Nonoperating expenses decreased by $52.7 million to $26.5 million compared with $79.2 million at June 30, 2006. The decrease is due primarily to eliminating the funding for Cal Grant program awards in 2006-07. This program was funded at $51 million in 2005-06 and $146.5 million in 2004-05.

MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)

Financial Analysis of the Federal Fund

At fiscal year ended June 30, 2007, the total net assets of the Federal Fund increased by $14.2 million to $71.3 million, compared to an increase of $8.8 million to $57.1 million at June 30, 2006. Net assets are comprised entirely of restricted balances. By federal regulations, restricted net assets represent the minimum reserve requirement and interest earnings from the restricted account. The earnings from the restricted account may be used only for performing specific default prevention activities and uses specified in the Commission's VFA with ED. This net asset change is primarily due to the items noted below.

- In 2006-07, total operating and nonoperating revenues decreased $6.5 million to $66.3 million, compared to an increase of $42.8 million to $72.8 million in 2005-06. This change resulted from the addition of the federal default fee which virtually eliminated the need for a minimum reserve subsidy.
- Fee subsidies consist mainly of DAF and WAF subsidies associated with the current VFA. DAF and WAF expenses are recorded net of refunds collected in the Federal Fund, and reflect adjustments in the respective allowance for refund accounts. In fiscal years 2006-07 and 2005-06, respectively, the Operating Fund charged the Federal Fund $13.2 million and $10 million in DAF expenses, net of DAF refunds and allowances and $7.7 million and $7.8 million in WAF expenses, net of WAF refunds and allowances.
- Loan default expense increased by $7.1 million in 2006-07 due to a rise in the rate of default across all school types and from increases in the overall size of the outstanding portfolio.
- The decrease in other expenses to $2.7 million from $24.7 million in 2006-07 and 2005-06, respectively, is due to the elimination of the account maintenance fee subsidy to the Operating Fund. Beginning in 2006-07 this fee is funded entirely from ED.
- The 1997 Balanced Budget Act required the Federal Fund return $165.1 million in nonoperating expense, with an additional $8.5 million as part of a second recall. The Commission remitted the entire first recall amount to ED in September 2002. The second recall required two equal installments of $8.2 million to be made in federal fiscal years 2006-07 and 2007-08. The installments are reflected as liabilities on the balance sheets.

Significant Known Facts, Decisions, or Conditions

Federal Default Fee and Federal Default Fee Subsidy

To remain competitive the Commission has adopted a new FDF sharing strategy for the 2007-08 academic year. Working with lenders who agree to participate, the Commission will share the FDF on Stafford, PLUS and Graduate PLUS loans. The Commission is optimistic that this strategy will be effective in retaining and growing student loan market share.

FELL Program Pending Legislation

The U.S. Congress recently passed H.R. 2669, The College Cost Reduction and Access Act, which includes various changes to the FFEL program that substantially impact the guarantor funding structure. The bill next goes to the President for signing and is reportedly expected to be signed with no threat of veto by October 2007. Provisions of the bill seek to improve college access and affordability with associated costs offset by decreases in other areas of the FFEL Program.

MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)

The most notable proposed changes that alter the guarantor funding model include:

- Reducing guarantor collection retention rates on regular borrower payments from 23 percent to 16 percent beginning October 1, 2007;
- Reducing the account maintenance fee from 0.10 percent to 0.06 percent;
- Reducing lender insurance rates;
- Repealing exceptional performer status.

Management has assessed the financial impact of these changes to the Operating Fund and Federal Fund. This analysis indicates and management believes that, although FFEL program revenues are reduced, both funds remain financially sound.

Sale of the Commission's Loan Guarantee Function

On August 24, 2007 the 2007-08 budget for the State of California was signed by the Governor. Included in the budget was legislation (Senate bills 89 and 91) providing for the sale of the Commission's loan guarantee function and nonprofit auxiliary organization (EDFUND) for an estimated $980 million to maximize the value of the state's assets related to implementation of the FFEL program.

It is anticipated the sale will take place during the last quarter of the state's fiscal year. As a consequence of this transaction, the state will resume funding for the cost of the Commission's state operations and financial aid awareness programs. Information about the 2007-08 budget for the State of California is available through the Department of Finance budget website (www.ebudget.ca.gov).

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

BALANCE SHEETS

June 30, 2007 and 2006

	Operating Fund	
	2007	2006
ASSETS		
Current assets:		
Cash and cash equivalents (Note 4)	$ 20,518,978	$ 27,806,485
Interest receivable	224,767	229,503
Other receivables	74,580	89,720
Due from Federal government (Note 6)	10,216,066	34,956,312
Total current assets	31,034,391	63,082,020
Noncurrent assets:		
Capital assets, net of accumulated depreciation (Note 5)	294,967	238,781
Advance to EDFUND (Note 16)	20,000,000	20,000,000
Total noncurrent assets	20,294,967	20,238,781
Total assets	$ 51,329,358	$ 83,320,801
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	$ 1,628,852	$ 908,959
Due to EDFUND (Note 16)	7,412,962	16,961,653
Due to Federal Fund	2,004,819	27,525,680
Due to General Fund (Note 9)	3,064,942	3,008,003
Allowance for default aversion fees (Note 6)	10,148,049	7,705,724
Allowance for early withdrawal fees (Note 7)	3,062,314	2,180,793
Total liabilities	27,321,938	58,290,812
Net assets:		
Investment in capital assets (Note 5)	294,967	238,781
Unrestricted	23,712,453	24,791,208
Total net assets	24,007,420	25,029,989
Total liabilities and net assets	$ 51,329,358	$ 83,320,801

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

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

BALANCE SHEETS

June 30, 2007 and 2006

	Federal Fund	
	2007	2006
ASSETS		
Current assets:		
Cash and cash equivalents (Note 4)	$ 30,889,834	$ 15,559,213
Restricted cash (Notes 4 and 10)	153,000	2,394,826
Total cash and cash equivalents	31,042,834	17,954,039
Interest receivable	204,286	125,224
Due from Federal government	34,093,345	37,523,154
Due from EDFUND (Note 16)	22,066,309	4,462,595
Due from Operating Fund	2,004,819	27,525,680
Default aversion fees receivable (Note 6)	10,148,049	7,705,724
Early withdrawal fees receivable (Note 7)	3,062,314	2,180,793
Total assets	$ 102,621,956	$ 97,477,209
LIABILITIES AND NET ASSETS		
Current liabilities:		
Due to lending institutions	$ 23,117,642	$ 23,917,937
Federal reserve recall, current portion (Note 10)	8,207,730	8,207,730
Total current liabilities	31,325,372	32,125,667
Noncurrent liabilities:		
Federal reserve recall, noncurrent portion (Note 10)	-	8,207,730
Total liabilities	31,325,372	40,333,397
Net assets:		
Restricted (Notes 10 and 14)	71,296,584	57,143,812
Total liabilities and net assets	$ 102,621,956	$ 97,477,209

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

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

For the Years Ended June 30, 2007 and 2006

	Operating Fund	
	2007	2006
Operating revenues:		
Net recoveries on loan defaults (Note 8)	$ 73,513,809	$ 53,083,412
Administrative and program fee income (Note 6)	63,776,853	58,420,491
VFA revenue (Note 7)	7,736,096	35,739,662
Lender premium fees (Note 13)	1,322,542	-
Other revenues	607,520	94,144
Total operating revenues	146,956,820	147,337,709
Operating expenses:		
Loan program personnel costs (Note 15)	55,536,587	53,482,932
Operating expenses (Note 17)	23,556,657	24,822,231
Federal default fee subsidy (Note 12)	25,512,597	-
Minimum reserve subsidy (Note 14)	9,392,146	69,089,312
Contracted collection costs	9,159,345	9,434,257
Total operating expenses	123,157,332	156,828,732
Operating income (loss)	23,799,488	(9,491,023)
Nonoperating revenues (expenses):		
Interest income (Note 4)	1,691,024	2,442,124
Grant administrative costs (Notes 9 and 15)	(14,404,157)	(11,502,485)
Financial aid awareness programs	(12,108,924)	(16,702,526)
Total nonoperating expenses	(24,822,057)	(25,762,887)
Transfers:		
Transfer to State of California's General Fund for Cal Grant program awards (Note 18)	-	(51,000,000)
Change in net assets	(1,022,569)	(86,253,910)
Net assets, beginning of year	25,029,989	111,283,899
Net assets, end of year	$ 24,007,420	$ 25,029,989

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

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

For the Years Ended June 30, 2007 and 2006

	Federal Fund	
	2007	2006
Operating revenues:		
Federal default fee (Note 12)	$ 47,237,617	$ -
Minimum reserve subsidy (Note 14)	9,392,146	69,089,312
Claim purchase complement	7,767,186	3,055,089
Other revenues	719,589	25,202
Total operating revenues	65,116,538	72,169,603
Operating expenses:		
Loan default expenses (Note 11)	28,555,800	21,452,421
Default prevention and VFA expenses (Note 10)	2,459,248	3,645,935
Account maintenance fee (Note 6)	-	21,084,443
Default aversion fee (Note 6)	13,196,309	10,000,462
Early withdrawal fee (Note 7)	7,736,096	7,772,444
Other operating expenses	231,064	-
Total operating expenses	52,178,517	63,955,705
Operating income	12,938,021	8,213,898
Nonoperating revenues:		
Interest income (Notes 4 and 10)	1,214,751	645,922
Change in net assets	14,152,772	8,859,820
Net assets, beginning of year	57,143,812	48,283,992
Net assets, end of year	$ 71,296,584	$ 57,143,812

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

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

STATEMENTS OF CASH FLOWS

For the Years Ended June 30, 2007 and 2006

	Operating Fund	
	2007	2006
Cash flows from operating activities:		
Receipts from:		
Collections	$ 69,568,641	$ 54,107,392
Administrative fees	64,594,888	61,792,608
Voluntary flexible agreement	42,971,634	1,250,480
Advance payment for purchases of defaulted loans	-	20,490,169
Lender premium fee	1,322,542	-
Other sources	607,521	94,144
Payments for:		
General administrative and other expenses	(94,710,837)	(74,714,612)
Federal default fee	(25,460,191)	-
Minimum reserve subsidy	(41,630,191)	(41,792,774)
Net cash provided by operating activities	17,264,007	21,227,407
Cash flows from noncapital financing activities:		
Payments for grant administrative costs	(14,028,098)	(11,478,395)
Financial aid awareness programs	(12,108,924)	(16,702,526)
Transfer for Cal Grant program awards	-	(51,000,000)
Net cash used in noncapital financing activities	(26,137,022)	(79,180,921)
Cash used in capital financing activities:		
Purchase of capital assets	(112,246)	(262,871)
Cash flows provided by investing activities:		
Interest received	1,697,754	2,929,289
Decrease in cash and cash equivalents	(7,287,507)	(55,287,096)
Cash and cash equivalents, beginning of year	27,806,485	83,093,581
Cash and cash equivalents, end of year	$ 20,518,978	$ 27,806,485
Reconciliation of operating income (loss) to net cash provided by operating activities:		
Operating income (loss)	$ 23,799,488	$ (9,491,023)
Adjustments to reconcile operating income (loss) to net cash provided by operating activities:		
Change in assets and liabilities:		
Receivables	15,140	(7,362)
Federal Government	24,740,247	(27,331,225)
General Fund	56,939	(783,759)
EDFUND	(9,550,685)	14,629,072
Federal Fund	(25,520,861)	41,054,928
Accounts payable	399,893	237,447
Allowance for default aversion and early withdrawal fees	3,323,846	2,919,329
Total adjustments	(6,535,481)	30,718,430
Net cash provided by operating activities	$ 17,264,007	$ 21,227,407

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

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

STATEMENTS OF CASH FLOWS

For the Years Ended June 30, 2007 and 2006

	Federal Fund	
	2007	2006
Cash flows from operating activities:		
Receipts from:		
Reimbursement on default purchases	$ 638,631,136	$ 534,500,511
Federal default fee	42,218,342	-
Minimum reserve subsidy	41,630,191	41,792,774
Other sources	8,619,965	2,907,293
Payments for:		
Administrative fees	(31,118,854)	(35,044,899)
Purchases of default student loans	(684,805,489)	(571,526,023)
General administrative and other expenses	(3,185,338)	(3,700,829)
Net cash provided by (used in) operating activities	11,989,953	(31,071,173)
Cash flows provided by investing activities:		
Interest received	1,098,842	626,120
Increase (decrease) in cash and cash equivalents	13,088,795	(30,445,053)
Cash and cash equivalents, beginning of year	17,954,039	48,399,092
Cash and cash equivalents, end of year	$ 31,042,834	$ 17,954,039
Reconciliation of operating income to net cash provided by (used in) operating activities:		
Operating income	$ 12,938,021	$ 8,213,898
Adjustments to reconcile operating income to net cash provided by (used in) operating activities:		
Change in assets and liabilities:		
Federal government	(4,777,921)	1,193,039
EDFUND	(17,566,867)	892,652
Operating Fund	25,520,861	(41,054,928)
Due to lending institutions	(800,295)	2,603,495
Allowance for default aversion and early withdrawal fees	(3,323,846)	(2,919,329)
Total adjustments	(948,068)	(39,285,071)
Net cash provided by (used in) operating activities	$ 11,989,953	$ (31,071,173)

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

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS

1. ORGANIZATION AND OPERATIONS

The California Student Aid Commission (the "Commission"), an agency of the State of California created in 1955, is responsible for the administration of California's student financial aid programs, which include the Federal Family Education Loan (FFEL) Program and state grant and specialized programs.

The FFEL Program was established by Congress and is administered by the U.S. Department of Education (ED) through the Commission and other guaranty agencies. As a guaranty agency, the Commission guarantees loans made available through lending institutions to students attending colleges, universities, postsecondary and vocational schools. The FFEL Program allows the Commission to guarantee repayment of principal and accrued interest to lenders for eligible student loans. The Commission has the responsibility of processing loans submitted for guarantee, issuing loan guarantees, providing default aversion assistance and prevention activities, providing collection assistance to lenders for delinquent loans, paying lender claims for loans that default, and performing collection activities on loans after purchase by the Commission.

The 1998 Reauthorization of the Higher Education Act (1998 Amendments) were enacted on October 6, 1998 and changed the manner in which the FFEL Program is administered. Under the Amendments, the Commission established a Federal Student Loan Reserve Fund (Federal Fund) and a Student Loan Operating Fund (Operating Fund) as required to account for FFEL Program activities. The FFEL Program is composed of Stafford, PLUS and Consolidation loans, and the residual activities of the Guaranteed Student Loan Program, which ceased to provide loans in 1967. The Federal Fund assets and earnings on those assets may only be used to pay for claim payments, default aversion fees and any other purposes authorized by ED and are considered the property of ED. The Operating Fund is a state fund within the custody and control of the Commission and its assets and earnings may be used for all guaranty agency and student financial aid-related activities. The accompanying financial statements reflect the activities of the Operating Fund and Federal Fund (Funds) of the Commission.

The Commission also administers the state Cal Grant program, under which state funded monetary grants are given to students to help pay for college expenses. The administrative costs associated with these programs are included in the Operating Fund's accompanying financial statements; however, the Cal Grant awards are not included in the accompanying financial statements.

2. SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Accounting

The Commission's Operating Fund and Federal Fund follow fund accounting under accounting principles generally accepted in the United States of America in which resources are classified for accounting and reporting purposes into funds established according to their purpose.

THE OPERATING FUND AND FEDERAL FUND OF THE
CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

2. **SIGNIFICANT ACCOUNTING POLICIES** (Continued)

(a) Basis of Accounting (Continued)

The loan program consists of the Federal Fund and the Operating Fund. The Federal Fund largely reflects the organization's FFEL Program insurance activities, while the Operating Fund accounts for substantially all FFEL Program operational activity, financial aid awareness and related outreach, and non-FFEL program grant administration activity in support of the state Cal Grant and specialized programs. The two funds are accounted for as business-type activities using the flow of economic resources measurement focus and the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when the liability is incurred regardless of the timing of the related cash flow.

In accordance with Government Accounting Standards Board (GASB) Statement Number 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, the Operating and Federal Funds apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions, issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. These Funds have not applied accounting standards issued after November 30, 1989 by the FASB.

(b) Cash and Cash Equivalents

For the purposes of the financial statements, cash and cash equivalents are defined as financial instruments with an original maturity of three months or less. Funds invested in the Surplus Money Investment Fund (SMIF) are considered cash equivalents.

(c) Restricted Cash and Cash Equivalents

Cash that is externally restricted for default prevention activities is included as a cash and cash equivalent in the Statements of Cash Flows.

(d) Capital Assets

Capital assets are those assets purchased or acquired with an original cost of $5,000 or more. Additions, improvements or other capital outlays that significantly extend the useful life of an asset are capitalized. These assets are reported at historical cost and are depreciated using the straight-line method over their estimated useful lives of three to five years. Costs incurred for repairs and maintenance are expensed as incurred. Depreciation of $138,420 and $24,090 is included in the Operating Fund's grant administrative costs for the years ended June 30, 2007 and 2006, respectively.

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(e) Net Assets

The Commission's net assets are classified as follows:

- Investment in capital assets – This represents the Commission's total investment in capital assets, net of outstanding debt obligations related to those capital assets to the extent the proceeds from the debt have been expended for capital assets.
- Restricted net assets – expendable – Restricted expendable net assets include resources that the Commission is legally or contractually obligated to spend in accordance with restrictions imposed by external third parties.
- Unrestricted net assets – Unrestricted net assets represent resources derived from and expended on behalf of the Operating Fund.

(f) Operating Revenues and Expenses

Operating revenues and expenses generally result from activities associated with the FFEL Program, including collecting on defaulted loans, default prevention and default loan purchase activities. All revenues and expenses not derived from the administration of the FFEL Program are reported as nonoperating revenues and expenses.

(g) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Management estimates include useful lives in depreciating capital assets and anticipated future default aversion fee refunds and early withdrawal fee. Actual results could differ from these estimates.

(h) Reclassifications

Certain reclassifications have been made to prior year's balances to conform to classifications used in 2007.

THE OPERATING FUND AND FEDERAL FUND OF THE
CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

3. GUARANTEED LOANS OUTSTANDING

As of June 30, 2007 and 2006, the Commission was the guarantor of a portfolio of outstanding loans with original principal amounts of approximately $27.2 billion and $25.2 billion, respectively. These loans were made to students by participating lenders and are guaranteed by ED.

The Commission's management anticipates that a certain portion of the FFEL Program loans outstanding as of June 30, 2007 will go into default status in the future requiring the use of the Federal Fund to purchase defaulted loans from lenders. The Federal Fund will subsequently be reimbursed by ED, at its applicable rates, for payments made to lenders for these defaulted loans.

4. CASH AND CASH EQUIVALENTS

Cash is maintained in the Surplus Money Investment Fund (SMIF). The SMIF consists of available cash of all special funds of the State of California which do not have investment authority of their own. Cash balances in excess of needs in any of these participating funds are invested by the State Treasurer. The State Treasurer's Office reports its investments at fair value. The Pooled Money Investment Board (PMIB) provides regulatory oversight over the State Treasurer's pooled investment program and is responsible for determining whether any cash balances of the participating funds are in excess of current needs and available for investment, or whether it is necessary to liquidate previous investments to meet current requirements. The PMIB is comprised of the State Treasurer, as chair, State Controller, and Director of Finance for the State of California. The Commission follows the investment policy of the State Treasurer. Additional information, including Investment Credit Type, Interest Rate Risk, and Concentration of Credit Risk is available at the State Controller's website (www.sco.ca.gov).

All of the resources of the SMIF are invested through the Pooled Money Investment Account (PMIA). The State Treasurer is restricted by state code as to the types of investments that can be made in the following categories: U.S. Government securities; securities of federally-sponsored agencies; domestic corporate bonds; interest-bearing time deposits in California banks, savings and loan associations and credit unions; prime-rated commercial paper; repurchase and reverse repurchase agreements; security loans; banker's acceptances; negotiable certificates of deposit and loans to various bond funds.

THE OPERATING FUND AND FEDERAL FUND OF THE
CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

4. CASH AND CASH EQUIVALENTS (Continued)

At June 30, 2007 and 2006 the allocation of the carrying value plus accrued interest purchased of the SMIF investments and cash held by the Operating Fund and Federal Fund approximated as follows (in 000's):

	June 30, 2007		June 30, 2006	
	Operating Fund	Federal Fund	Operating Fund	Federal Fund
SMIF:				
U.S. Treasury Securities	$ 992	$ 1,573	$ 1,423	$ 924
Federal Agency Securities	4,390	6,959	8,025	5,209
Bank Notes	388	615	474	308
Certificates of Deposit	4,652	7,374	5,958	3,867
Commercial Paper	4,289	6,798	5,132	3,331
Corporate Bonds	115	182	420	272
Time Deposits	2,608	4,133	3,430	2,226
AB55 and General Fund loans	2,149	3,407	2,798	1,816
Other	936	2	146	1
Total	$ 20,519	$ 31,043	$ 27,806	$ 17,954

The value of the deposits in the State Treasurer's pooled investment program (program), including the SMIF, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2007 and 2006, this difference was immaterial to the valuation of the deposits held by the Federal Fund and Operating Fund in the SMIF. The pool is run with "dollar in, dollar out" participation. There are no share-value adjustments to reflect changes in fair value. The Federal Fund and Operating Fund share in the interest earnings of PMIA based on the ratio that their dollar-day contributions bear to the dollar-day investments of the PMIA.

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

5. CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2007 is as follows:

	2007			
	Beginning Balance	Additions	Transfers/ Disposals	Ending Balance
Vehicles	$ 61,181			$ 61,181
Computer equipment	972,989	$ 142,937	$ (58,415)	1,057,511
Computer software	627,661	219,306		846,967
Office equipment	2,469,988		(23,946)	2,446,042
Furniture and fixtures	14,481			14,481
Construction in progress	167,637		(167,637)	
	4,313,937	362,243	(249,998)	4,426,182
Less accumulated depreciation:				
Vehicles	(61,181)			(61,181)
Computer equipment	(939,764)	(58,803)	58,415	(940,152)
Computer software	(605,905)	(75,671)		(681,576)
Office equipment	(2,453,825)	(3,946)	23,946	(2,433,825)
Furniture and fixtures	(14,481)			(14,481)
	(4,075,156)	(138,420)	82,361	(4,131,215)
Capital assets, net	$ 238,781	$ 223,823	$ (167,637)	$ 294,967

Capital asset activity for the year ended June 30, 2006 is as follows:

	2006			
	Beginning Balance	Additions	Transfers/ Disposals	Ending Balance
Vehicles	$ 61,181			$ 61,181
Computer equipment	923,615	$ 49,374		972,989
Computer software	601,533	26,128		627,661
Office equipment	2,450,256	19,732		2,469,988
Furniture and fixtures	14,481			14,481
Construction in progress		167,637		167,637
	4,051,066	262,871		4,313,937
Less accumulated depreciation:				
Vehicles	(61,181)			(61,181)
Computer equipment	(923,615)	(16,149)		(939,764)
Computer software	(601,533)	(4,372)		(605,905)
Office equipment	(2,450,256)	(3,569)		(2,453,825)
Furniture and fixtures	(14,481)			(14,481)
	(4,051,066)	(24,090)		(4,075,156)
Capital assets, net	$ -	$ 238,781	$ -	$ 238,781

THE OPERATING FUND AND FEDERAL FUND OF THE
CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

6. ADMINISTRATIVE AND PROGRAM FEES

The 1998 Amendments established that certain fees would be paid to the Operating Fund for administering the loan program on behalf of the federal government based on guaranty agency performance. These fees are known as the Default Aversion Fee (DAF), the Loan Processing and Issuance Fee (LPIF), and the Account Maintenance Fee (AMF).

The DAF is earned for default aversion activities on delinquent loans at the time lenders request aversion assistance, between the 60th and 120th days of a borrower's delinquency. A fee of 1 percent of principal and interest on the loan may be charged to the Federal Fund at the time the guaranty agency receives a request from a lender for default aversion assistance. However, the fee must be refunded by the Operating Fund to the Federal Fund if the loan is later paid as a default claim. Accordingly, an estimate of DAF refunds has been calculated and is presented as an Operating Fund liability and a receivable in the Federal Fund. The net DAF is transferred from the Federal Fund to the Operating Fund on a monthly basis.

The LPIF is based on the original principal amount of new loans guaranteed and disbursed during the period. The fee is calculated at a rate of 0.40 percent of disbursed dollars and paid to the Operating Fund by ED on a quarterly basis.

The AMF is calculated at 0.10 percent of the original principal amount of loans outstanding at federal year end. The fee is calculated on an annual basis and was paid by ED in 2007 and by the Federal Fund in 2006.

As of June 30, 2007 and 2006, the administrative and program fees receivable, which are included in the net amount due from federal government (ED), consisted of the following:

	2007	2006
Operating Fund:		
LPIF receivable	$ 3,236,594	$ 3,995,439
AMF receivable	6,979,472	3,783,741
	$ 10,216,066	$ 7,779,180

For the years ended June 30, 2007 and 2006, total administrative and program fee income recognized is as follows:

	2007	2006
Operating Fund:		
DAF, net of refunds and related allowance	$ 13,196,309	$ 10,000,462
LPIF	22,174,896	22,485,762
AMF	28,405,648	25,934,267
	$ 63,776,853	$ 58,420,491

THE OPERATING FUND AND FEDERAL FUND OF THE
CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

6. ADMINISTRATIVE AND PROGRAM FEES (Continued)

Gross DAF income for the years ended June 30, 2007 and 2006 was $20,729,358 and $15,359,333, respectively. The estimated allowance for DAF refunds is netted against DAF income. Based on current and historical data, the Commission's management estimated that certain DAF income will have to be refunded from the Operating Fund to the Federal Fund. The dollar amount of the allowance for DAF income as of June 30, 2007 and 2006 was $10,148,049 and $7,705,724, respectively. The activity in the allowance for DAF refunds for the years ended June 30, 2007 and 2006 is as follows:

Beginning balance as of July 1, 2005	$ 6,046,767
Provisions	5,358,871
Refunds	(3,699,914)
Ending balance as of June 30, 2006	7,705,724
Provisions	7,533,049
Refunds	(5,090,724)
Ending balance as of June 30, 2007	$ 10,148,049

7. VOLUNTARY FLEXIBLE AGREEMENT

The 1998 Amendments established the Voluntary Flexible Agreement (VFA) as a pilot program allowing selected guaranty agencies to negotiate alternative fee structures and implement other default prevention initiatives and programs. In January 2001, the Commission entered into a VFA with ED. As a result, three alternative revenue sources were developed:

- Shared claims savings
- Performance based collections
- Early withdrawal fee

The Commission, through the performance based features of the Voluntary Flexible Agreement (VFA), received $7.7 million in 2006-07 solely from Early Withdrawal Fee funding generated from borrower default prevention counseling efforts. While this fee funding is comparable with the $7.8 million generated in 2005-06, the Operating Fund did not qualify for shared claims savings or performance based collections under the VFA in 2006-07. For the year ended 2005-06, the Operating Fund earned $14.2 million and $13.8 million in shared claims savings and performance based collections, respectively.

At ED's request, EDFUND on behalf of the Commission submitted a revised VFA proposal to renegotiate the terms of the current VFA. Specific agreement changes and effective dates have not yet been agreed upon and the status of ED's proposal evaluation is unclear. However, the current VFA is still in place.

THE OPERATING FUND AND FEDERAL FUND OF THE
CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

7. VOLUNTARY FLEXIBLE AGREEMENT (Continued)

At June 30, 2007 and 2006, the Operating Fund has an allowance for Early Withdrawal Fee (WAF) revenues in the amount of $3,062,314 and $2,180,793, respectively. The activity in the allowance for WAF for the years ended June 30, 2007 and 2006 is as follows:

Beginning balance as of July 1, 2005	$ 920,421
Provisions	1,260,372
Ending balance as of June 30, 2006	2,180,793
Provisions	881,521
Ending balance as of June 30, 2007	$ 3,062,314

8. NET RECOVERIES ON LOAN DEFAULTS

The Commission's management is required by federal statutes to pursue collections on loans upon default of payment. Collections on defaulted loans and related complements are recorded at the time such collections are received. The Operating Fund retains approximately 23 percent of borrower payments. For loans that have been rehabilitated (effective July 1, 2006, 9 on-time payments in a 10-month period; previously, 12 consecutive monthly payments made by the defaulted borrower) or consolidated out of default by a third-party refinancing, the Commission is allowed by federal regulation to retain a percentage of the total amount received relating to the retirement of the post-default obligation. Net recoveries on loan defaults for the year ended June 30, 2007 and 2006 are as follows:

	2007	2006
Net regular payment recoveries	$ 24,232,588	$ 9,898,652
Net FFEL consolidation loans	195,197	5,345,068
Net rehabilitation loans	43,063,074	8,531,384
Net federal direct consolidation loans	6,022,950	29,308,308
Total net collection recoveries	$ 73,513,809	$ 53,083,412

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

9. DUE TO GENERAL FUND

Beginning in 2002-03, the State appropriated funding for the Commission's administrative budget for FFEL Program and outreach and training activities, as well as funding for the California Student Opportunity and Access Program (Cal-SOAP) as a reimbursement from the Operating Fund to the General Fund. The Commission's Cal-SOAP program continued as a reimbursement from the Operating Fund to the General Fund through 2006-07. Beginning in 2003-04, the State appropriated the Commission's entire administrative budget directly from the Operating Fund. For the years ending June 30, 2007 and 2006, the Commission administrative activities expended from the Operating Fund were $14,404,157 and $11,502,485, respectively. The Commission's Operating Fund had a net liability to the General Fund representing outstanding reimbursements of $3,064,942 and $3,008,003 as of June 30, 2007 and 2006, respectively.

10. FEDERAL RESERVE RECALL

The 1997 Budget Reconciliation Act (ACT) required the return of a total of $1 billion in federal reserves from all FFEL Program guaranty agencies. The Commission made all of the required deposits to a restricted account and remitted them to ED.

Interest earned from the restricted fund within the Federal Fund may only be used for performing specific default prevention activities and for early withdrawal fees transferred to the Operating Fund as stipulated in the VFA between the Commission and ED. The restricted account earned a total of $64,422 and $168,472 in interest revenue and a total of $2,459,248 and $3,645,935 was incurred in default prevention expenses for the years ended June 30, 2007 and 2006, respectively. The restricted account balance was $153,000 and $2,394,826 as of June 30, 2007 and 2006, respectively.

In addition to the $1 billion Federal Reserve return, the 1998 Amendments to the Higher Education Act contain a provision for an additional recall of Federal Reserve funds held by guaranty agencies totaling $250 million nationwide. ED notified the Commission that its share of this recall would be $24,871,909. The first installment of $8,456,449 was remitted to ED in September 2002, with $16,415,460 due in two equal installments of $8,207,730 in September 2006 and 2007, respectively. The remaining final installment is reflected as a current liability at June 30, 2007.

11. LOAN DEFAULT EXPENSE

The loan default expense represents the purchases of defaulted loans, net of reinsurance received from ED and loans repurchased by lenders as recorded in the Federal Fund. Effective July 1, 2006, lenders are paid an amount representing 97 percent of principal and calculated interest. The federal government then reimburses the Federal Fund a percentage of the default claims paid based on the default rates of the portfolio as follows:

Loans guaranteed before October 1, 1993	100 percent
Loans guaranteed between October 1, 1993 through September 30, 1998	98 percent
Loans guaranteed on or after October 1, 1998	95 percent

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

11. LOAN DEFAULT EXPENSE (Continued)

Effective July 1, 2006, qualified lenders designated for exceptional performance (EP) receive 99 percent reimbursement on claims submitted for insurance during the 12-month period following the date the lender and its guarantors receive notification. The Commission currently has fifteen lenders participating in the EP program. The Federal Fund's reinsurance rate range of 95 percent to 98 percent remains unchanged.

12. FEDERAL DEFAULT FEE AND FEDERAL DEFAULT FEE SUBSIDY

Federal regulations authorized the assessment of an insurance premium as a source of revenue for the Federal Fund. During federal fiscal years 1996 through 2006, the Commission waived assessing the insurance premium.

The Higher Education Reconciliation Act of 2005 replaced the insurance premium with a Federal Default Fee (FDF), as defined in 20 U.S.C. 1078(b)(1)(H)(ii). Under HERA, the Federal default fee of 1 percent of the principal amount of the loan, shall be collected either by deduction from the proceeds of the loan or by payment from other non-Federal sources.

In keeping with the commitment of waiving the previous insurance premium or FDF to borrowers through the remainder of federal fiscal year 2006, the Commission agreed to pay the FDF on their behalf for loans guaranteed July 1, 2006 through September 30, 2006. For loans guaranteed on or after October 1, 2006, the FDF was deposited by lenders.

13. LENDER PREMIUM FEE

During fiscal year ending June 30, 2007, a contractual relationship was established with a lending partner. This agreement includes a scaled premium fee paid by the lender when purchasing loans qualifying for rehabilitation.

14. RESERVE FOR LOAN DEFAULTS

Pursuant to the 1998 Amendments, Section 428(c)(9), a guaranty agency is required to maintain a minimum Federal Fund reserve level of at least .25 percent of the total original principal amount of all outstanding loans guaranteed by such agency. The purpose of the reserve is to ensure that the Commission is able to fulfill obligations relative to the overall outstanding portfolio.

Based on the original principal outstanding balance as of June 30, 2007 and 2006, the required reserve was $68,057,342 and $54,748,986, respectively. The Federal Fund is in compliance with the required minimum reserve calculation as of June 30, 2007 and 2006, respectively.

THE OPERATING FUND AND FEDERAL FUND OF THE CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

14. RESERVE FOR LOAN DEFAULTS (Continued)

Through September 30, 2006, while the federal default fee was waived, management opted to subsidize the Federal Fund, when needed, by transferring funds from the Operating Fund to ensure the minimum reserve level was maintained. For the years ended June 30, 2007 and 2006, the Operating Fund subsidized $9,392,146 and $69,089,312, respectively.

15. PENSION BENEFITS

As of June 30, 2007 and 2006, 46 and 56, respectively, of the Commission's permanent civil service employees were assigned to EDFUND, the Commission's auxiliary, in direct support of FFEL Program activities. As of June 30, 2007 and 2006, 118 and 101, respectively, of the Commission's permanent civil service employees supported the programs administered by the Commission, respectively. Full-time civil service employees participate in the California Public Employees' Retirement System (PERS). PERS, a multiple-employer defined benefit retirement plan, is administered by a Board of Administration composed of individuals (1) elected by PERS membership; (2) appointed by elected State of California officials; and (3) elected State of California officials. PERS provides retirement, disability, and death benefits. Such benefits are based on the employee's years of service, age, and final compensation. PERS issues a publicly available financial report that includes financial statements and required supplementary information, which may be obtained by writing to California Public Employees' Retirement System, 400 P Street, Sacramento, CA 94229-2701.

Civil service employees may participate in PERS at one of three levels; first-tier participants contribute a portion of their salaries to a retirement fund; second-tier employees do not make contributions; and Alternate Retirement Program (ARP) participants contribute to a special retirement account for the first two years of State service. The ARP was established for State of California employees hired on or after August 11, 2004. The Department of Personnel Administration's website (www.dpa.ca.gov) has additional information about this program. As of June 30, 2007 and 2006, 43 and 51, of the employees assigned to EDFUND were classified as first-tier and 3 and 5 employees were classified as second-tier, respectively. As of June 30, 2007 and 2006, 93 and 86 of the Commission's employees who supported the programs administered by the Commission were classified as first-tier, and 7 and 2 employees, respectively, were classified as second-tier. As of June 30, 2007 and 2006, 18 and 13 of the Commission employees, respectively, who supported the programs administered by the Commission were classified as ARP.

15. PENSION BENEFITS (Continued)

All new State civil service employees are automatically enrolled in ARP for the first two years of employment with the State. After two years, employees will have the option of choosing between the first-tier and second-tier. In addition to the employee's contributions to PERS, the State also contributes into PERS towards civil service retirement benefits. The State's contribution varies annually based on the Budget Act. First-tier employees vest after five years of State service and may receive retirement benefits at age 50. Second-tier employees vest after ten years of State service and may receive retirement benefits at age 55. State records relating to pension benefit obligations and net assets available for benefits are not separately available for the Funds.

The Operating Fund paid total pension expense and funded contributions of $483,299 and $526,930 in 2007 and 2006, respectively, for employees supporting loan program activity and assigned to EDFUND. The Operating Fund also paid $994,042 and $835,782 in 2007 and 2006, respectively, for Commission employees who supported the grant and outreach programs administered by the Commission. All contributions were paid as of June 30, 2007 and 2006, respectively.

16. RELATED PARTY TRANSACTIONS

The Commission established EDFUND effective January 2, 1997. EDFUND is governed by a 13-member Board of Directors who are nominated and appointed by the Commission. The Board is required to have at least one commissioner, one EDFUND employee and one student enrolled in a California postsecondary educational institution serving as directors at all times. The President of EDFUND and the Executive Director of the Commission serve as ex-officio members of the Board.

EDFUND provides operational and support services essential to the administration of the FFEL Program through an Operating Agreement with the Commission. The Operating Agreement is for one year and is renewed annually.

On January 2, 1997, the Commission advanced $20 million to EDFUND for operating capital. This advance is reported in the Operating Fund as an advance to EDFUND. EDFUND uses the advance for monthly operating expenses which are subsequently reimbursed in part by the Operating Fund and for default provision activities which are subsequently reimbursed in part by the Restricted Fund and the remaining amount by the Operating Fund.

In February 1997, EDFUND entered into a noncancelable operating lease for its office facility that expires in November 2007 and has been extended to August 2008. The Commission subleased the office facility and, pursuant to the provisions of the operating agreement, will reimburse EDFUND for actual costs incurred including preparing and maintaining the facility for occupancy. In November 2006, EDFUND entered into a $47.5 million noncancelable operating lease for its new office facility that expires in 2017. The Commission has not committed to a sublease; hence, the $47.5 million obligation is not included in the future minimum lease payments disclosure in Note 17.

THE OPERATING FUND AND FEDERAL FUND OF THE
CALIFORNIA STUDENT AID COMMISSION

NOTES TO FINANCIAL STATEMENTS
(Continued)

16. RELATED PARTY TRANSACTIONS (Continued)

As of June 30, 2007 and 2006, the net amount due to EDFUND from the Operating Fund was $7,412,962 and $16,961,653, respectively. As of June 30, 2007 and 2006, the net amount due from EDFUND to the Federal Fund was $22,066,309 and $4,462,595, respectively.

17. LEASES

The Commission leases office and storage space under noncancelable operating leases and month-to-month agreements. Total rental expense recorded in the Operating Fund, which includes utilities for one of two major leases, for the years ended June 30, 2007 and 2006 approximated $3,573,000 and $3,517,000, respectively. The future minimum lease payments for the noncancelable operating leases are as follows (in 000's):

Year Ending June 30,	
2008	$ 4,287
2009	1,243
2010	105
2011	30
	$ 5,665

18. CAL GRANT PROGRAM AWARDS

For the year ended June 30, 2006, the Commission remitted $51 million to the State of California's General Fund to support the Cal Grant Program. For the year ended June 30, 2007, the Commission did not remit funds to California's General Fund to support the Cal Grant Program. These grants are awards made to students to help pay for college expenses.

19. CONTINGENCIES

During the normal course of business, the loan program is involved in various legal proceedings and investigations of its operations and activities. While these proceedings and investigations may lead to a possible liability, in the opinion of the Commission's management, these possible liabilities will not have a material adverse effect on the financial position or operations of the Operating Fund or Federal Fund.

20. SUBSEQUENT EVENTS

FFEL Program Pending Legislation

The U.S. Congress recently passed H.R. 2669, The College Cost Reduction and Access Act, which includes various changes to the FFEL program that substantially impact the guarantor funding structure. The bill next goes to the President for signing and is reportedly expected to be signed with no threat of veto by October 2007. Provisions of the bill seek to improve college access and affordability with associated costs offset by decreases in other areas of the FFEL program.

The most notable proposed changes that alter the grantor funding model include:

- Reducing guarantor collection retention rates on regular borrower payments from 23 percent to 16 percent beginning October 1, 2007.
- Reducing the account maintenance fee from 0.10 percent to 0.06 percent.
- Reducing lender issuance rates.
- Repealing exceptional performer status.

Management has assessed the financial impact of these changes to the Operating Fund and Federal Fund. This analysis indicates and management believes that, although FFEL program revenues are reduced, both funds remain financially sound.

Sale of the Commission's Loan Guarantee Function

On August 24, 2007, the 2007-08 budget for the State of California was signed by the Governor. Included in the budget was legislation (Senate bills 89 and 91) providing for the sale of the Commission's loan guarantee function and nonprofit auxiliary organization (EDFUND) for an estimated $980 million to maximize the value of the State's assets related to implementation of the FFEL program.

It is anticipated the sale will take place during the last quarter of the State's fiscal year. As a consequence of this transaction, the State will resume funding for the cost of the Commission's state operations and financial aid awareness programs. Information about the 2007-08 budget for the State of California is available through the Department of Finance budget website (www.ebudget.ca.gov).

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To the Audit Committee and the Honorable Members
California Student Aid Commission
Rancho Cordova, California

This letter is intended to inform the Audit Committee and Honorable Members of the California Student Aid Commission about significant matters related to the conduct of the annual audit of the Student Loan Operating Fund and Federal Student Loan Fund (collectively "the Funds") so that it can appropriately discharge its oversight responsibility, and that we comply with our professional responsibilities to the Audit Committee and Honorable Members.

The following summarizes various matters which must be communicated to you under auditing standards generally accepted in the United States of America.

The Auditor's Responsibility Under Generally Accepted Auditing Standards

Our audit of the financial statements of the Student Loan Operating Fund and Federal Student Loan Fund (collectively "the Funds") of the California Student Aid Commission for the year ended June 30, 2007 was conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error, fraudulent financial reporting or misappropriation of assets. 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. Accordingly, the audit was designed to obtain reasonable, rather than absolute, assurance about the financial statements. We believe that our audit accomplished that objective.

In accordance with *Governmental Auditing Standards*, we have also performed tests of controls and compliance with laws and regulations that contribute to the evidence supporting our opinion on the financial statements. However, they do not provide a basis for opining on the Funds' internal control or on compliance and other matters.

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of the preparation of financial statements and are based upon management's current judgment. The process used by management encompasses their knowledge and experience about past and current events and certain assumptions about future events. Management has informed us that they used all the relevant facts available to them at the time to make the best judgments about accounting estimates, and we considered this information in the scope of our audit. Estimates significant to the financial statements include the estimates of the useful lives on depreciating capital assets and the allowances for default aversion fees and early withdrawal fees. The Audit Committee and Honorable Members may wish to monitor throughout the year the process used to compute and record these accounting estimates.

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Audit Adjustments

There was one audit adjustment made to the original trial balance presented to us to begin our audit. This adjustment was to accrue accounts payable of approximately $320,000 for grant administrative costs.

Potential Adjustments

We noted no potential adjustments that were not made to the financial statements.

Accounting Policies and Alternative Treatments

Management has the ultimate responsibility for the appropriateness of the accounting policies used by the Funds. The following new accounting policies have been issued by the Governmental Accounting Standards Board and will be adopted in future years by the Funds:

- Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions.*
- Governmental Accounting Standards Board Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.*
- Governmental Accounting Standards Board Statement No. 50, *Pension Disclosures, an Amendment of GASB Statements No. 25 and 27.*
- Governmental Accounting Standards Board Statement No. 51, *Accounting and Financial Reporting for Intangible Assets.*

Management of the Funds does not expect the adoption of these standards to have a significant impact on its financial position or results of operation.

We did not identify any significant or unusual transactions or significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

Other Information in Documents Containing Audited Financial Statements

We are not aware of any other documents that contain the audited financial statements. If such documents were to be published, we would have a responsibility to determine that such financial information was not materially inconsistent with the audited financial statements of the Funds.

Disagreements with Management

We encountered no disagreements with management over the application of significant accounting principles, the basis for management's judgments on any significant matters, the scope of the audit or significant disclosures to be included in the financial statements.

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Consultations with Other Accountants

We are not aware of any consultations management had with other accountants about accounting or auditing matters.

Major Issues Discussed with Management Prior to Retention

No major issues were discussed with management prior to our retention to perform the aforementioned audit.

Difficulties Encountered in Performing the Audit

We did not encounter any difficulties in dealing with management relating to the performance of the audit.

* * * * *

We will be pleased to respond to any questions you have about the foregoing. We appreciate the opportunity to continue to be of service to the California Student Aid Commission.

This report is intended solely for the information and use of the Audit Committee, Honorable Members and management and is not intended to be and should not be used by anyone other than the specified parties.

Perry-Smith LLP

Sacramento, California
September 26, 2007

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

The Audit Committee and the Honorable Members
California Student Aid Commission
Sacramento, California

We have audited the financial statements of the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission, as of and for the year ended June 30, 2007, and have issued our report thereon dated September 26, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's internal control over financial reporting. Accordingly, we do not express an opinion of the effectiveness of the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's financial statements that is more than inconsequential will not be prevented or detected by the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's internal control.

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

(Continued)

Internal Control Over Financial Reporting (Continued)

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Audit Committee and management and is not intended to be and should not be used by anyone other than those specified parties.

Perry-Smith LLP

Sacramento, California
September 26, 2007

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To the Audit Committee and the Honorable Members
California Student Aid Commission
Sacramento, California

In planning and performing our audit of the California Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's financial statements for the year ended June 30, 2007, we considered its internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. Accordingly, we do not express an opinion on the effectiveness of the California Student Loan Operating Fund and Federal Student Loan Fund of the California Student Aid Commission's internal control. However, we identified a deficiency in internal control over financial reporting (control deficiency).

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect financial statement misstatements on a timely basis. A deficiency in design exists when a control necessary to meet the control objective is missing, or when an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met. A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

A significant deficiency is a control deficiency, or a combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

A material weakness is a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Because of the inherent limitations of internal control, errors or fraud may occur and not be detected. Also, projection of any evaluation of the internal control to future periods is subject to the risk that internal control may become inadequate because of changes in conditions or that the degree of compliance may deteriorate.

Our consideration of internal control would not necessarily disclose all matters that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses as defined above.

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We noted the following matter, which we consider to be a control deficiency, but that we believe does not rise to the level of a significant deficiency or material weakness:

Currently, services received but not invoiced, for grant administration costs of the Operating Fund, are not accrued at year end as accounts payable. The Commission accountants monitor the commitments and related expenditures through the State encumbrance system under the modified accrual basis. However, accounts payable items in the encumbrance system for which services had been received as of June 30, 2007 were not accrued under the full accrual basis.

We recommend the encumbrance report be reviewed at each reporting date and that grant administration costs, for which services have been received, be accrued in the financial reporting process for any costs still to be paid out of the Operating Fund.

This communication is intended solely for the information and use of the Audit Committee, Honorable Members and management and is not intended to be and should not be used by anyone other than these specified parties.

Perry-Smith LLP

Sacramento, California
September 26, 2007

5.c

Action Item

California Student Aid Commission

Update on Cal Grant New Application Eligibility Internal Audit

The Commission entered into a contract in October 2006 with the Department of Finance to develop and implement an audit program for an audit of new Cal Grant applicant eligibility. This audit was included in the Commission's Internal Audit Plan for 2005-2007. The contract with the Department of Finance was necessary because the Commission had recently separated the CSAC and EDFUND internal audit responsibilities in response to a recommendation by the Bureau of State Audits. The internal audit functions had previously been the responsibility of EDFUND's Vice President of the Audit Services Division.

The Department of Finance has completed the field work and has prepared a draft of the audit report. Any findings and recommendations are confidential until a final report is issued.

CSAC staff is preparing a management response to the draft report and will submit it to the Department of Finance by November 21, 2007

Responsible Staff: Keith Yamanaka
Chief Deputy Director