STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

Commission for Postsecondary Education

REPORT HIGHLIGHTS
PERFORMANCE AUDIT

Subject

The Commission for Postsecondary Education (Commission) was first established by executive order in 1974 and was later authorized by statute in 1994. The Commission administers several programs that help students pay for postsecondary education.

Our Conclusion

Although its investment performance has been mixed, Arizona's 529 program offers most of the features of a high-quality program. The Commission can further improve the program by having providers collect customer service and satisfaction information. The Commission's monitoring of providers has improved, but it should establish additional performance criteria to evaluate providers, and strengthen its contract provisions.

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Arizona's 529 program has most features of high-quality program

The Commission oversees the Arizona Family College Savings Program (a 529 program), which is based on section 529 in the Internal Revenue Code authorizing states to set up the program. Under the program, a person can set up an investment account for a child or adult who will be attending a postsecondary educational institution, such as a college, university, or vocational school.

Investments in an Arizona 529 account, such as mutual funds and a nontraditional certificate of deposit (CD), can be made until the account balance reaches $304,000. Account monies are distributed to the beneficiary tax-free for qualified educational expenses.

Qualified educational expenses include tuition, fees, books, supplies, equipment required for enrollment, and certain room and board expenses.

529 program's mutual fund investment performance has been mixed—The Commission has an Oversight Committee that monitors the mutual fund providers' investment performance. The providers establish their own benchmarks using a combination of the S&P 500 stock index and the Citigroup BIG bond index.

One provider, Waddell and Reed, has two portfolios that have outperformed their benchmarks, a third portfolio that has not met its benchmark, and 17 other portfolios that are too new to evaluate. Another provider, Fidelity, has 27 portfolios that are too new to evaluate.

Program has important features—Despite its mixed investment performance, Arizona's 529 program has five of six important features that are associated with high-quality programs.[1] Arizona's features include:

- **Low fees and expenses for accountholders**—Fees and expenses potentially decrease investment gains. Previously, some of Arizona's providers' products had high fees, but in 2006, the Commission took action and did not renew these providers' contracts. Currently, the fees and expenses that Arizona accountholders pay compare favorably overall with highly rated providers in other states.
- **State incentive**—States can provide incentives to invest in college savings plans such as state tax deductions. Effective January 1, 2008, Arizona allows a deduction of up to $750 for single filers and up to $1,500 for joint filers for contributions to any state's 529 program.

1 Auditors used provider ratings on savingforcollege.com and Morningstar to identify states with highly rated providers.

- **Range of investment choice**—Investors should have a variety of investment products to meet their needs. Arizona's mutual fund providers offer 47 different portfolios. By comparison, two states with highly regarded providers, Ohio and Colorado, offer a total of 32 and 20 portfolios, respectively. Arizona also offers a nontraditional CD investment option.
- **High limit on account contributions**—High limits permit participants to invest a significant amount of money that can be withdrawn tax-free when used for qualified educational expenses. As of August 2007, the limit was $304,000, placing Arizona in the top third of state 529 programs.
- **Low required-minimum contributions**—Low required-minimum contributions permit individuals of all income levels to contribute to a 529 program. In Arizona, these minimums vary by investment provider, but are comparable to minimums in other states with highly rated providers.

Greater focus needed on customer service—The one factor absent in Arizona's program that is found in some other high-quality programs is ensuring quality customer service. The Commission does not require providers to collect and provide information on customer satisfaction, nor does it include customer service benchmarks in its provider contracts. Colorado conducts an annual customer satisfaction survey, and Oregon reviews tape-recorded customer service phone calls.

Customer satisfaction information would allow the Commission to measure customer service issues, such as how long customers who call in to service centers have to wait for help and the effectiveness of providers' marketing programs. The Commission's Oversight Committee plans on asking providers for customer satisfaction data and benchmarks beginning in 2008.

Other investment opportunities—The Commission also offers a nontraditional CD for college savings. The provider, College Savings Bank, offers a CD that is based on the future cost of college. The CD is sold in units, with one unit equal to 1 year of college tuition, fees, and room and board at the CD's maturity date. Investors pay more than the current cost of college to receive assurance that the future cost of college will be covered. The annual percentage rate of the CD will rise parallel with the inflation of college cost.

Recommendations

The Commission should:

- Determine what customer satisfaction information it needs and require providers or commission staff to collect it.
- Add customer service standards to its provider contracts, based on the Oversight Committee's determination of the best way to use customer satisfaction information.

The Commission's Oversight Committee should:

- Continue to monitor performance of mutual funds and take action as needed.
- Determine the best way to use customer satisfaction information to evaluate providers.

Provider monitoring should be further enhanced

Before 2006, the Commission exercised only limited oversight over its providers. Although the Commission has taken steps to significantly improve the situation, additional steps can still be taken.

Increased Oversight Committee Review—Before 2006, oversight was largely limited to a review of providers' quarterly reports. However, in 2006, the Commission's Oversight Committee began holding annual provider review meetings. Auditors attended the 2007 meeting and observed that providers were required to provide, and were questioned about, various issues, including their return on investments, fees, and marketing activities. The Oversight Committee also receives monthly reports from providers regarding new accounts and assets under management.

Although the Oversight Committee is now more actively overseeing the providers, the Oversight Committee can further strengthen its efforts by:

- **Standardizing and documenting review methodology**—The Oversight Committee's provider evaluation form guides members to consider eight criteria specified in statute. However, the criteria are not weighted or prioritized, and members are not required to document their consideration of the criteria.
- **Evaluating partnership**—The Oversight Committee should add review criteria to evaluate its partnership with providers.

Commission should strengthen provider contracts—When renegotiating its 529 provider contracts, the Commission should establish additional provisions to strengthen the contracts. For example, the contracts do not explain what happens to accounts if the contract is not renewed. If the Commission does not adopt a policy to disallow sales charges imposed when accountholders' shares are sold, it should ensure that future contracts provide for a transfer of accounts to a new provider without cost to the accountholders.

The contracts should also require all providers to submit their annual audited financial statements and a review of information technology (IT) security efforts to ensure that they have adequate controls in place. The Commission should also consider a requirement that if providers undergo a review of internal controls, they must submit the results to the Oversight Committee.

The Commission should also add an asset-based fee agreement to all its 529 provider contracts when renegotiating the contracts. The Commission has an agreement in its contract with Waddell and Reed to receive a fee based on the percentage of assets invested in Waddell and Reed accounts on or after November 18, 2006. Waddell and Reed is the only provider with such a contract provision. In addition, the Commission does not yet have rules in place to allow it to accept and use these fees.

Recommendations

The Commission should:

- Strengthen provider contracts by adding provisions to cover:
    - Transferring accounts to a new provider if a provider contract is not renewed, unless the Commission adopts a policy to disallow sales charges imposed when accountholders sell shares.
    - Auditing financial statements and reviewing providers' IT security.
    - Requiring a contractual assets-based fee provision with all of its providers, and establishing rules governing the use of these fees.

The Commission's Oversight Committee should:

- Standardize and document its provider review methodology.

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