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Performance Audit Division

Performance Audit and Sunset Review

Commission for Postsecondary Education

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Debra K. Davenport
Auditor General

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STATE OF ARIZONA

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October 15, 2007

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mike Rooney, Chairman
Commission for Postsecondary Education

Dr. April Osborn, Executive Director
Commission for Postsecondary Education

Transmitted herewith is a report of the Auditor General, A Performance Audit and Sunset Review of the Commission for Postsecondary Education. This report is in response to a May 22, 2006, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Commission agrees with all of the findings and plans to implement all of the recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on October 16, 2007.

Sincerely,

Debbie Davenport
Auditor General

Enclosure

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SUMMARY

The Office of the Auditor General has conducted a performance audit and sunset review of the Commission for Postsecondary Education (Commission), pursuant to a May 22, 2006, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

The Commission was established in 1974 by executive order to fulfill a requirement of the federal Education Amendments of 1972 that a postsecondary commission be created to make states eligible for grant funding under the 1972 law. In the years since creation, the Commission has been either under the supervision of the Arizona Board of Regents or an independent entity. A 1991 executive order made the Commission into an independent agency, and it has remained so since that time.

The Commission administers several programs that help students pay for postsecondary education. One of these programs is the Arizona Family College Savings Program, also known as the 529 program. This program provides both Arizona residents and nonresidents with an opportunity to invest monies for future educational expenses, and exempts investment gains from federal income tax if they are used for qualified educational expenses. Further, in 2007, the Arizona Legislature passed a tax deduction of up to $1,500 for contributions to any state 529 program, including programs in other states. The 529 program contracts with investment providers, including College Savings Bank, Fidelity, and Waddell and Reed, to manage individual accountholders' investments. Morningstar, which provides financial analysis regarding 529 programs and other investments, criticized the Commission in 2004, 2005, and 2006 for the poor quality of some of its providers. The Commission addressed some of these criticisms by prohibiting two providers, Pacific Life and Securities Management and Research, from taking on new accountholders after November 18, 2006. In March 2007, Morningstar's report did not include Arizona's providers in its list of poor-quality 529 providers. Further, the Legislature's action to provide a tax deduction for contributions addressed an additional incentive that Morningstar encourages investors to consider.

In addition to the 529 program, the Commission administers financial assistance programs and provides other services related to postsecondary education.

Arizona's 529 program offers most features of a high-quality program (see pages 11 through 18)

The Arizona 529 program has five of the six features of a high-quality program, and its mutual funds' investment performance is monitored. The Arizona 529 program has two mutual fund providers, Waddell and Reed and Fidelity. Waddell and Reed has offered three basic portfolios to accountholders since 2001. Since that time, two of the portfolios have outperformed their benchmark, and one portfolio has not. In June 2007, the Commission approved Waddell and Reed's proposal to make 17 new portfolios available to accountholders, and these portfolios are too new to evaluate. Fidelity began offering actively managed portfolios to investors in 2005, and none of the 11 portfolios that debuted in 2005 have met their benchmarks. However, the 2 years of investment performance is not enough to fully evaluate the quality of Fidelity's offerings. The Oversight Committee, which makes recommendations to the Commission regarding the Arizona 529 program, should continue to monitor the mutual funds' investment performance and take appropriate action as necessary.

Arizona's 529 program has five important features, but should adopt one additional feature. The five features include:

- **Low fees and expenses**—The Commission has worked to reduce fees and expenses by terminating providers that did not reduce fees to an acceptable level, and its current mutual fund providers' fees and expenses are comparable to plans in states where all providers are highly rated.

- **State tax deduction**—The Legislature enacted a measure in 2007 that provides a deduction of up to $1,500 for accountholders' contributions in any state 529 program.

- **Range of choice**—The Arizona 529 program offers 47 different mutual fund portfolios and a CD option to accountholders. This represents a greater range of choices than some states, such as Ohio and Colorado, with highly rated providers.

- **High limit on contributions**—Accountholders can contribute to their Arizona account until the total account holdings reach $304,000 per beneficiary.

- **Low-minimum contributions**—Accountholders can contribute as little as $15 per month in some provider plans.

Although Arizona's 529 program has several important features, the Commission should improve its knowledge of providers' customer service by determining what customer service and customer satisfaction information it needs, and requiring that providers or commission staff collect the information. Once this information is received, the Oversight Committee should determine the best way to use this information to evaluate the providers. Further, based on the Oversight Committee's determination, the Commission should add customer service benchmarks to its provider contracts to ensure that the standard of customer service evaluation is clear to the 529 program providers.

In addition to its mutual funds, the Commission offers a nontraditional Certificate of Deposit (CD) option that combines aspects of a prepaid tuition plan and a traditional CD. This CD option is like a prepaid tuition plan in that it guarantees accountholders who purchase a full unit that the value will be sufficient to pay for 1 year of future college costs, although accountholders can instead choose to purchase a portion of a unit. The price of a unit is higher than the estimated cost of college, and accountholders receive a variable rate of return based on a benchmark called the IC 500, which tracks national changes in college costs, minus a percentage set by the provider. In the year ending July 31, 2006, CD accountholders saw an annual percentage yield of between 2.74 and 5.74 percent, depending on when the CD was purchased (see Appendix, Table 7, page a-vii).

Provider monitoring has improved, but should be further enhanced (see pages 19 through 25)

The Commission should build on recent improvements in provider oversight. First, the Oversight Committee's recently enhanced monitoring of the Commission's investment providers could be further improved. The Oversight Committee had previously relied on quarterly reports to oversee the providers, but in 2006 also began holding an annual provider review meeting at which committee members hear providers' presentations and ask various questions. However, the Committee should make additional improvements. Specifically, the Oversight Committee should standardize its review of providers, including documenting its consideration of eight statutory criteria and developing a way to assess the level of providers' partnership with the Commission. The Oversight Committee should also explore the feasibility of establishing qualitative or quantitative standards for the areas it evaluates.

In addition, the Commission should improve provider oversight by strengthening its contracts with providers in three ways. First, if the Commission does not adopt a policy disallowing the sale of mutual fund shares carrying sales charges that must be paid when account shares are sold, it should establish contract provisions requiring that, in the event of a provider's termination or nonrenewal, the provider must transfer the accounts to a new provider in a way that does not impose additional costs on the accountholders. Second, the Commission should require that all 529 providers submit audited financial statements to the Oversight Committee. Third, the Commission should require that 529 providers undergo a review of their information technology security and report the results to the Oversight Committee.

Finally, the Commission has a provision in its contract with Waddell and Reed to receive a fee based on a percentage of the assets generated by new Waddell and Reed accounts, but the Commission does not have a similar provision in its other providers' contracts.[1] Fee agreements such as this one can provide a 529 program with additional monies to use in administering the program, and other state programs, such as Ohio, Oregon, and Colorado, have such agreements with providers. A.R.S. §15-1873(A)(6) requires the Commission to charge fees for any agreements, contracts, or transactions related to the 529 program. This requirement applies to the Commission's imposition of fees on all providers. The Commission plans to include an asset-based fee provision in its other providers' contracts when the contracts are renewed. The Commission should continue its efforts to add this provision to its other provider contracts and ensure that rules allowing the Commission to accept the fees are adopted to allow the Commission to use the monies. Additionally, the Commission should ensure that these rules only allow the monies to be used for expenses related to the 529 program.

1 Under the contract provision, Waddell and Reed will make monthly payments to the Commission, calculated at an annual rate of 0.15 percent of the average value of assets. The average value is calculated monthly by adding the aggregate asset value as of the first business day of the month and as of the last business day of the month, and dividing the sum by two.

TABLE OF CONTENTS

continued

TABLE OF CONTENTS

Figures:

Tables:

concluded •

INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a performance audit and sunset review of the Commission for Postsecondary Education (Commission), pursuant to a May 22, 2006, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

Commission's history

The Commission was established in 1974 by executive order to fulfill a requirement of the federal Education Amendments of 1972 that a postsecondary commission be created to make states eligible for grant funding under the 1972 law. In the years since its creation, the Commission has been either under the supervision of the Arizona Board of Regents or an independent entity. A 1991 executive order made the Commission independent of the Board of Regents, and it has remained so since that time.

Commission programs and staffing

The Commission has 16 members, including representatives from various sectors of postsecondary education in Arizona: public universities, community colleges, private universities and colleges, and private technical and trade schools. State statute sets the qualifications for the Commission's members, which include a member of the business community; two senior executives from high school districts; one charter school owner, operator, or administrator; and the executive directors of the Board of Regents and the Arizona Board for Private Postsecondary Education. Other than the two executive directors, the commissioners are appointed by the Governor and can serve up to two consecutive 4-year terms.

The Commission oversees Arizona's 529 program and several programs that provide financial aid to students who attend a postsecondary institution or may do so in the future, encourages dialogue on issues related to postsecondary education in Arizona, oversees policy analysis work, and conducts outreach to potential postsecondary students. Specifically:

- **529 program**—529 programs, so-called after the section of the federal Internal Revenue Code in which they are created, exist in 49 of 50 states and the District of Columbia, and are a way for people to invest money for a particular beneficiary's college expenses. These programs are typically administered by states, and most states, including Arizona, allow nonresidents to participate in their 529 program. Proceeds of this investment are distributed tax-free if they are used for qualified educational expenses. In addition, 529 program balances are not counted when the student applies for any state financial aid in Arizona, although program balances are counted as an asset of the account owner for federally based financial aid programs.

  Federal Internal Revenue Code allows states to set up 529 programs and specifies certain criteria, such as who can be a beneficiary for a 529 account and what counts as a qualified educational expense. However, each state is given some freedom to structure its own program. For example, each state determines how its program will be administered, and can set program fees. Arizona requires an enrollment fee of $10 and an administrative fee of $3 for each new account, which goes to support the Commission's administration of the 529 program.[1] Arizona also allows residents of other states to invest in its 529 program. As shown in Table 1 (see page 4), as of June 30, 2007, Arizona's 529 program providers handled the investment of approximately $422 million contained in the program's 45,161 funded accounts. Arizona residents owned 5,270, or about 12 percent, of these accounts, which contained approximately $55 million.

  Accountholders also have some freedom when investing in a 529 program. For example, accountholders can set up multiple accounts, in Arizona or nationally, for a beneficiary. The beneficiary can be a child or an adult, and does not have to be related to the accountholder. Arizona conforms with the federal standards regarding who can be a beneficiary. Arizona's 529 program also allows accountholders to contribute up to $304,000 to all Arizona accounts tied to a single beneficiary. However, accountholders may open accounts for beneficiaries in other states' 529 programs as well. Finally, Arizona conforms with federal standards regarding the choice of postsecondary institution at which 529 account monies can be used.

  As of June 2007, the Commission has contracts with three investment providers—College Savings Bank, Fidelity, and Waddell and Reed—to set up and manage Arizona's 529 program accounts. These contracts are for 3 or 3 and a half years and can be extended up to a total possible contract term of 7 years. The three providers collectively offer a range of investment options for

1 In Arizona, the providers and not the accountholders pay these fees.

accountholders. These options include several different mutual funds and a nontraditional certificate of deposit (CD) that contains elements of both a CD and a prepaid tuition plan. Accountholders who invest in mutual funds can choose from two distinct options: age-based and static. Whichever option they choose, accountholders can also select from actively managed or index portfolios (see textbox).

The Commission receives advice regarding the 529 program from an Oversight Committee. The Oversight Committee is made up of ten members, two designated by statute and eight appointed by the Governor.[1] The Governor's appointees are required by statute to have experience with accounting, investments, or other related financial fields. The Oversight Committee is required to meet at least quarterly each calendar year and is charged with recommending which investment providers should be used. It may also recommend rules to be promulgated for oversight of the 529 program.

Arizona's 529 program received criticism regarding its providers in 2004, 2005, and 2006, and the Commission has taken action to address this criticism. From 2004 through 2006, Morningstar, which is a large financial analysis firm, released a review of state 529 providers in which it criticized some of the Commission's providers regarding issues such as high fees and the lack of quality investment options. In 2004, Morningstar listed Waddell and Reed and Securities Management and Research (SM&R) among the five worst providers, and in 2005, Morningstar stated that none of Arizona's providers, including Waddell and Reed, SM&R, and Pacific Life, were an attractive option. Finally, in 2006, Morningstar included Pacific Life and SM&R among its list of the seven worst 529 savings plans and recommended eliminating these providers. However, Morningstar did remove Waddell and Reed from the list of worst providers based on Waddell and Reed's reduction in fees.

In 2006, the Commission took action to address this criticism by terminating Pacific Life and SM&R, citing reasons such as the providers' high fees, and

Investment Options

Mutual Fund Options:

Age-based options change depending on the beneficiary's age. These portfolios include both actively managed mutual funds and index funds. They start out with a higher proportion of equity (stock) investments for younger beneficiaries with many years to go before college. As the beneficiary nears college age, the investments in the portfolio are reallocated to become more conservative, for example, by increasing the proportion bond investments.

Static options include both actively managed mutual funds and index funds that maintain an asset allocation that does not change as the beneficiary gets older.

Actively managed portfolios are managed by dedicated portfolio managers to attempt to generate returns greater than a major market index, such as the S&P 500, over the long term.

Index portfolios maintain investments in securities that are designed to generate returns mirroring the performance of a major market index over the long term.

Nontraditional Certificate of Deposit (CD) Option: The provider of this option guarantees that investors will receive the future cost of 4 years of college if they purchase four units of the CD. The purchase price for each unit is higher than current 1-year college costs. The CD pays an annual interest rate, which equals the annual percentage rise in college costs, as calculated by the Independent College 500 (IC 500) Index, minus a percentage price set by the provider. The CD option also has a minimum interest rate for added protection. The principal and interest are federally insured up to $100,000 per accountholder.

Source: Auditor General staff analysis of information on the College Savings Bank, Fidelity, and Waddell and Reed Web sites.

1 The two statutory appointees are the State Treasurer or the Treasurer's designee and the chairperson of the State Board for Private Postsecondary Education or the chairperson's designee.

Table 1: Number of Arizona 529 Program Accounts and Account Assets By Investment Provider As of June 30, 2007

	Total Accounts	Total Arizona Residents' Accounts	Total Account Assets	Total Arizona Residents' Account Assets
Providers Approved To Accept New Accounts				
College Savings Bank	3,108	1,035	$ 70,973,984	$15,569,692
Fidelity	4,105	2,445	33,501,831	25,740,557
Waddell and Reed	32,277	660	271,438,676	4,648,805
Providers Not Approved To Accept New Accounts[1]				
Pacific Life	3,802	485	37,791,981	5,045,605
Securities Management & Research	1,869	645	8,653,259	3,613,696
Total	45,161	5,270	$422,359,732	$54,618,355

1 In November 2006, the Commission did not renew its contracts with Pacific Life and Securities Management & Research providers because they were not making significant progress in lowering their fees. However, the Commission entered into new agreements with these providers that allowed the providers to manage their existing accounts for 1 year, but prohibited them from accepting new accounts.

Source: Auditor General staff analysis of information provided to the Commission by its investment providers.

prohibited these providers from accepting new accounts. However, the Commission entered into a new 1-year contract with the providers to manage their existing Arizona 529 accounts until the accounts could be transferred to another provider. In 2007, Morningstar did not include any Arizona providers among the nation's worst 529 program providers.

- **Financial assistance programs**—In addition to the 529 program, which helps students pay for college by providing investment options for college savings, the Commission oversees three programs that provide financial assistance to students.[1] (See Table 3, Appendix, pages a-ii and a-iii, for a summary of key facts about these programs.) Specifically:

  - Postsecondary Education Grant (PEG) program—The Legislature established the PEG program in 2006. In fiscal year 2007, the Legislature appropriated $4.8 million to the Commission to provide individual students with forgivable loans of up to $2,000 annually, as well as $200,000 to

1 In addition, Laws 2007, Chapter 280, created the Early Graduation Scholarship Program, which the Commission will administer. The Commission is required to develop application forms, procedures, and deadlines to implement and administer the program in conjunction with the Department of Education by November 1, 2007. This program provides students who graduate from an Arizona high school 1 year early, and are otherwise eligible, with up to $2,000 to be used for tuition, fees, and books over their first 2 academic years at a qualified regionally or nationally accredited public or private postsecondary educational institution or vocational program in Arizona. Eligible students who graduate from high school one semester early can receive up to $1,500 for tuition, fees, and books over their first 2 academic years.

administer the program.[1] There are several eligibility requirements. For example, students must be enrolled in a bachelor's degree program in a private, accredited postsecondary institution in Arizona, and students can receive the grant for a maximum of 4 years. The program requires that a recipient repay all grant monies received if he or she does not graduate from a baccalaureate program within 5 years. However, grant repayments will not begin until 2012, which is the first year in which 2007 grant recipients must have their bachelor's degree.

PEG program participation (as of June 30, 2007)

Total Grants:	1,077
Monies Disbursed:	$1,834,777

Source: Arizona Commission for Postsecondary Education.

Students apply for the grants directly to the Commission, which is required to give grants to eligible students in the order in which applications are received, but giving priority to previous grant recipients.

- Leveraging Educational Assistance Partnership (LEAP)—LEAP, established in 1972, is a federal, state, and institutional partnership that provides students grants of up to $2,500 per year. Students apply for them through their institutions and can receive these grants as long as they meet the eligibility requirements. The State of Arizona matches the funds provided by the federal government. To be eligible for LEAP, students must be residents of Arizona, attend an accredited institution at least half-time, and have demonstrated financial need. The Commission relies on the participating institutions to certify that students are eligible to receive LEAP funds, but conducts periodic reviews to assess whether students receiving funds are eligible.

- Private Postsecondary Student Financial Assistance Program (PFAP)—PFAP is a state-funded program that was established in 1996. PFAP provides eligible students with a forgivable loan of up to $1,500 per year, for up to 2 years, for tuition and fees. Students become eligible if they have received an associate's degree from a community college in Arizona and are enrolled full-time in an accredited private postsecondary institution chartered in the State.[2] Students apply directly to the Commission for PFAP monies and agree to reimburse the Commission for the amount of the PFAP monies awarded if they do not receive a bachelor's degree within 3 years of first receiving a PFAP award. The Commission collects the money that is owed by students who fail to graduate within 3 years of the first award. If the Commission is unable to collect the money, it turns the collection over to the Arizona Attorney General's Office.

- **Fostering interaction among postsecondary sectors**—State statute requires that the Commission provide a forum to public and private postsecondary education

1 Although the PEG program is called a grant program, the monies are disbursed in the form of a forgivable loan. A forgivable loan is a loan that does not have to be repaid unless the recipient fails to meet certain eligibility criteria, such as graduating within a certain number of years.

2 Under A.R.S. §15-1854, students must have graduated from either a community college district or from a community college that is under the jurisdiction of an Indian tribe in Arizona and that meets the same accreditation standards as a community college district.

institutions to discuss issues of mutual interest. One way that the postsecondary schools have interacted is through the Developing Human Capital Conference hosted by the Commission in April 2006. According to the Commission, this conference focused on developing a framework for understanding the role of higher education and exploring ways that various postsecondary sectors can work together to fulfill this role. The Commission also fosters interaction through its quarterly meetings, at which its broad range of members can discuss various issues related to postsecondary education, such as financial aid and postsecondary education preparation. These meetings are also periodically attended by other interested stakeholders, such as a representative from the Arizona Private School Association, and a representative of the State's student loan guarantor, USA Funds.

- **Policy analysis**—The Commission is authorized by statute to create policy analysis centers, which it has done through the creation and oversight of the Arizona Minority Education Policy Analysis Center (AMEPAC). AMEPAC comprises several members of the postsecondary education community, including professors at Arizona State University and the University of Arizona, and representatives from education interest groups and business groups. AMEPAC is responsible for various research reports, including 2006's *The Road to Higher Education: Closing the Participation Gaps for Arizona Minority Students*, which provides a framework for viewing minority student access and success in postsecondary institutions.

- **Outreach and education activities**—The Commission is also involved in outreach and education activities in various ways. For instance, the Commission meets its statutory requirement to compile and disseminate information to the public regarding postsecondary education opportunities in Arizona through its annual *Arizona College and Career Guide*. This publication lists course and tuition information from every postsecondary institution in the State that makes such information available. The Commission reported that in 2006 it distributed more than 15,000 of these guides to such locations as high schools and job centers throughout the State. The Commission also provides an updated version of the *College and Career Guide* on its Web site. Another of the Commission's outreach activities is its coordination of the state-wide College Goal Sunday, which is an initiative designed to educate high school and college students about the financial aid opportunities available for those wishing to attend a postsecondary institution.

To discharge these responsibilities, the Commission has nine FTEs. According to the Commission's business manager, six FTE positions were filled as of September 13, 2007. These FTEs include the executive director, the business manager, the office manager, and a clerical worker. There are also two staff members who handle student financial aid functions, including the PEG program administration. Finally, the Commission has a 529 administrator, whose functions include assisting the Oversight Committee in overseeing the contracts between the State and its 529 program providers, but as of September 13, 2007, this position was unfilled.

Budget and funding

As illustrated in Table 2, the Commission had approximately $8.7 million in revenues for fiscal year 2007, an increase of more than $5.2 million from fiscal year 2006. Most of this increase came from an appropriation of $5 million to the Commission for the PEG program. The Commission's expenditures in fiscal year 2007 also increased by

Table 2: Schedule of Revenues, Expenditures, and Changes in Fund Balance
Fiscal Years 2005 through 2007
(Unaudited)

	2005	2006	2007
Revenues:			
State General Fund appropriations	$1,391,300	$1,391,300	$6,620,800[1]
Intergovernmental:			
State and local	1,075,500	1,075,500	1,121,387
Federal	550,800	511,872	512,199
Donations[2]	288,885	374,716	306,656
License and permit fees	68,703	74,590	66,090
Interest on investments	25,696	28,355	47,620
Other	61,917	58,850	44,313
Total revenues	3,462,801	3,515,183	8,719,065
Expenditures and remittances to the State General Fund:[3]			
Personal services and employee-related	275,595	334,535	413,325
Professional and outside services	149,871	196,504	227,250
Travel	2,239	4,303	5,577
Student financial assistance	2,954,109	2,909,473	4,840,132[4]
Other operating	86,928	83,381	94,253
Total expenditures	3,468,742	3,528,196	5,580,537
Remittance to the State General Fund		10,968[5]	
Total expenditures and remittances to the State General Fund	3,468,742	3,539,164	5,580,537
Excess (deficiency) of revenues over expenditures and remittances	(5,941)	(23,981)	3,138,528
Fund balance, beginning of year	268,150	262,209	238,228
Fund balance, end of year	$ 262,209	$ 238,228	$3,376,756[6]

1 The increase in fiscal year 2007 is primarily related to a $5 million appropriation the Commission received for a Postsecondary Education Grant Program. This program was established by Laws 2006, Chapter 352, and provides up to $2,000 of financial assistance to eligible full- and part-time students enrolled at a private baccalaureate degree-granting institution.

2 Consists of private gifts, corporate sponsorships, and other private donations for various programs such as the Twelve Plus Partnership Program. In addition, includes general administrative monies received from postsecondary schools for the LEAP administration.

3 Administrative adjustments are included in the fiscal year paid.

4 Amount increased significantly in fiscal year 2007 because the Commission provided more than $1.8 million in grants to students for the new Postsecondary Education Grant Program.

5 According to the Commission, the amount represents monies remitted back to the State General Fund from a terminated program that recipients repaid as required by the program.

6 Nearly $3 million of this amount represents unexpended monies of the Postsecondary Education Grant Program.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Revenues and Expenditures by Fund, Program, Organization, and Object* report for fiscal years 2005 and 2006; the AFIS *Trial Balance by Fund* report for fiscal years 2005, 2006, and 2007; and the AFIS *Accounting Event Transaction File* for fiscal year 2007.

approximately $2 million. Most of this increase was because of the $1.8 million in PEG monies disbursed from March 2007, when PEG applications were first received, through June 30, 2007. The Commission had a fund balance at the end of fiscal year 2007 of approximately $3.4 million, of which nearly $3 million were PEG appropriations that were not disbursed. These monies were carried forward to fiscal year 2008.

Update of 1997 audit

The Arizona Office of the Auditor General released a performance audit and sunset review of the Commission in 1997 (see Report No. 97-19). This report found that the Commission was performing policy analysis that it did not have statutory authority to conduct. The report also found that the Commission had developed an extensive plan for early-awareness activities that it did not have statutory authority to conduct. The report recommended that the Legislature consider giving the Commission authority to perform policy analysis and early awareness activities. The report further recommended that if the Legislature did not want to grant this authority, then it should sunset the Commission and distribute its functions to other agencies.

Through Laws 1998, Chapter 235, the Legislature granted the Commission statutory authority to coordinate and promote studies of interest to postsecondary institutions in Arizona. This audit found that the Commission does not use the plan for early-awareness activities that the 1997 audit report concluded were outside the Commission's legal authority. Finally, the Legislature has given the Commission other responsibilities since the 1997 audit, including the administration of the 529 program and the PEG program.

Scope and methodology

This audit focused on the structure of the State's 529 program and the Commission and Oversight Committee's administration of the program. This report presents two findings and associated recommendations:

- Arizona's 529 program offers most features of a high-quality program (see Finding 1, pages 11 through 18).

- Although the Commission's oversight of the investment providers has recently been enhanced, provider oversight could be improved in several additional ways (see Finding 2, pages 19 through 25).

In addition, the report presents information related to the 12 sunset factors defined in A.R.S. §41-2954 (see pages 27 through 32).

Auditors used several methods to review the issues addressed in this audit, including interviews of commission staff, commission members, and Oversight Committee members; a review of commission statutes and rules; and attendance at commission and Oversight Committee meetings. In addition, auditors reviewed applicable federal laws related to state 529 programs. Further, auditors used the following specific methods:

- To develop information about the performance of Arizona's 529 program providers, auditors obtained performance history information from representatives of College Savings Bank, Fidelity, and Waddell and Reed. Auditors also reviewed unaudited Arizona 529 program performance information for each provider, as well as reviewing Fidelity's Web site for performance information from the four other state 529 programs for which it is a provider.[1] Further, auditors reviewed the 2006 provider annual reports submitted to the Oversight Committee.

- To identify the key features of high-quality 529 programs, auditors interviewed representatives from Morningstar and savingforcollege.com, which are well-recognized rating services for state 529 programs' providers, regarding the program features important to those services in determining program ratings. To further understand the importance of these features, auditors reviewed the ratings of state 529 program providers by Morningstar for 2005, 2006, and 2007 and by savingforcollege.com as of August 2007, as reported on their respective Web sites. Auditors also interviewed executives from the state 529 programs in Colorado, Ohio, Oregon, and Rhode Island to determine how their programs were structured and what they felt were the key features of a high-quality 529 program. These states were selected for the overall quality of their 529 providers, as determined by Morningstar and savingforcollege.com, and to represent different regions of the country and differing amounts of assets under management.[2] Further, auditors reviewed literature on state 529 programs to determine additional information regarding key features. Finally, auditors reviewed information from the College Savings Plan Network's (CSPN) Web site to learn more information about other state 529 programs.[3]

- To develop information about the adequacy of oversight of Arizona's 529 program, auditors reviewed the Commission's contracts with Fidelity and Waddell and Reed, its 2003 Request for Proposals to determine requirements that apply to College Savings Bank, as well as the contracts the Commission entered into in November 2006 with Pacific Life and SM&R to allow them to continue to manage their existing 529 accounts. In addition, auditors attended the annual provider review meeting and interviewed representatives from College Savings Bank, Fidelity, and Waddell and Reed. To determine how some

1 These states are California, Delaware, Massachusetts, and New Hampshire.

2 Many states have highly rated providers: Alaska, Colorado, Connecticut, Georgia, Iowa, Louisiana, Maryland, Minnesota, Missouri, Mississippi, New Mexico, New York, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Utah, Virginia, and West Virginia. Washington, D.C., also has highly rated providers.

3 CSPN is an affiliate of the National Association of State Treasurers and compiles 529 program information from the states for general informational purposes.

other state 529 program requirements compare to Arizona's, auditors conducted interviews with representatives of the four states mentioned above. Auditors also obtained and reviewed information from Ohio regarding its evaluation of providers and information from Oregon regarding its provider contracts and due-diligence reviews.

- To develop information for the Introduction and Background section, auditors attended an AMEPAC meeting and reviewed the Commission's *College and Career Guide* and information about College Goal Sunday. Further, auditors reviewed JLBC appropriations reports for the Commission for fiscal years 2006 and 2007. Auditors also interviewed representatives of two postsecondary institutions regarding the Commission's distribution of grant monies, as well as a representative of the Attorney General's Office regarding the collection of monies owed under programs administered by the Commission, such as PFAP. Finally, auditors reviewed a variety of unaudited information from the Commission, including staffing levels and responsibilities and the number of applications and amount of funds disbursed under the PEG program, LEAP, and PFAP.

- To develop information for the sunset factors, auditors interviewed a representative of the Attorney General's Office and obtained information from the Secretary of State's Office regarding various open meeting law requirements. Auditors also obtained from the Governor's Regulatory Review Council an assessment of the extent to which the Commission's rules comply with statutory mandates. To determine the different types of state 529 oversight bodies, auditors obtained information from the CSPN Web site regarding the office that administers each of the fifty 529 programs. Finally, auditors reviewed HB2710 from the 2006 legislative session, which did not pass, but would have moved oversight of the 529 program to the Arizona Office of the State Treasurer.

This audit was performed in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Commission, the Oversight Committee, and the Commission's Executive Director and staff for their cooperation and assistance throughout the audit.

FINDING 1

Arizona's 529 program offers most features of a high-quality program

Arizona's Family College Savings Program, also known as the 529 program, has most of the features of a high-quality 529 program, although the investment performance of the program's mutual funds has been mixed or is too new to evaluate. Accordingly, the Oversight Committee, which makes recommendations to the Commission regarding the Arizona 529 program, should continue to monitor the mutual fund's investment performance. In addition, auditors identified six characteristics associated with high-quality 529 programs. Although Arizona has most of these, the Committee does not obtain much information regarding customer service offered by the investment providers, unlike Colorado, Ohio, and Oregon. Finally, the Commission offers a nontraditional Certificate of Deposit (CD) option to potential investors that combines aspects of a CD and a prepaid tuition plan.

Mutual fund investment performance has been mixed, or is too new to conclusively evaluate

Many investment options in Arizona's 529 program are too new to conclusively evaluate for performance.

Investment returns for some mutual funds offered in Arizona's 529 program have varied, and in many cases the portfolios are too new to conclusively evaluate. The Oversight Committee assesses the Commission's two mutual fund providers' (Fidelity and Waddell and Reed) investment performance in relation to set benchmarks. Two of Waddell and Reed's three portfolios have outperformed their benchmarks since inception (see Appendix Table 4, page a-iv), while their 17 new portfolios are too new to evaluate for performance. Fidelity's portfolios are also too new to conclusively evaluate for performance, although thus far most of its portfolios have failed to meet their benchmarks (see Appendix Tables 5, page a-v, and Table 6, page a-vi). The Oversight Committee should continue to monitor the performance of all of the mutual fund options to ensure that they meet or exceed their benchmarks, and take appropriate action as necessary.

Oversight Committee uses benchmarks for mutual fund providers—The Oversight Committee monitors the investment performance of the mutual fund providers through advising the investment providers on their performance benchmarks and periodically receiving performance reports from providers. According to an Oversight Committee member, investment providers determine the benchmarks for the mutual funds' investment performance, and the Committee advises the investment providers on their benchmark selection. The mutual funds' benchmarks are intended to illustrate the relative performance of certain asset classes and may be based on stock or bond indices, or a combination of both, if necessary. For instance, Waddell and Reed uses a blended benchmark composed of the S&P 500 (80 percent) and Citigroup BIG (20 percent) to evaluate its growth portfolio. The S&P 500 is a commonly used stock index, and the Citigroup BIG is a commonly used American bond index.[1]

Two of three Waddell and Reed portfolios have outperformed benchmarks; newer portfolios too new to conclusively evaluate performance—According to a Waddell and Reed official, until June 2007, Waddell and Reed offered Arizona 529 plan investors three portfolios with differing tolerance for risk. Two of these three original portfolios have outperformed their benchmarks since their inception in 2001. For example, as shown in Table 4 (see Appendix, page a-iv), the Waddell and Reed Growth Portfolio has yielded a 9.11 percent return on investment since inception, compared to 7.96 percent for its benchmark. However, the Waddell and Reed Conservative portfolio has significantly underperformed its benchmark, yielding only 3.72 percent since inception, compared to 5.85 percent for its benchmark. In June 2007, the Commission approved Waddell and Reed's proposal to add 17 new portfolios to its 529 offerings. These portfolios are newly created and do not have any prior performance history.

Fidelity has requested to replace some of its funds with higher-performing funds.

Fidelity's investment portfolios too new to be conclusively evaluated for performance—Fidelity became a provider in Arizona's 529 program in 2005, and thus its funds have a limited performance history (see Appendix, Table 5, page a-v, and Table 6, page a-vi). Consequently, while none of its 11 actively managed funds have met Fidelity's selected performance benchmarks since their inception, it is difficult to gauge the funds' quality based on this brief snapshot of performance. Even so, Fidelity has already requested that the Commission approve a plan to replace some of the funds used in its 529 program with other, higher-performing funds. In addition to its actively managed funds, since 2006, Fidelity has provided investors with 15 index fund options, some of which have outperformed Fidelity's selected performance benchmarks (see Appendix, Table 6, page a-vi). Index funds are designed to closely mirror the performance of a market index, such as the S&P 500, over the long term.

Oversight Committee should continue to monitor performance—Since the performance of Waddell and Reed's three original portfolios is mixed, and Fidelity and Waddell and Reed collectively have added over 40 different

1 BIG is an acronym for Broad Investment Grade.

investment portfolios since 2005, the Oversight Committee should continue to monitor the performance of all of the mutual fund options to ensure that they meet or exceed their benchmarks, and the Commission should take appropriate action as necessary based on the Oversight Committee's recommendations. For example, the Oversight Committee could recommend that providers remove low-performing portfolios from their 529 program offerings. Finding 2 (pages 21 through 28) contains additional discussion of ways that the Oversight Committee and the Commission could improve oversight of 529 providers, including performance oversight.

Arizona's 529 program has several important features, but should adopt one additional feature

Arizona's 529 program has several important features, but should adopt one additional feature (see textbox). Auditors identified six qualities identified by experts or shared by states with highly rated 529 providers, and Arizona has five of them: low fees and expenses, a state-based incentive for investing in its 529 program, range of investment choice, high limit on account contributions, and low required monthly contributions.[1] However, the Commission could improve the 529 program through better ensuring that its providers offer quality customer service.

Important 529 Program Features

Features in Arizona's program:

- Low fees and expenses
- State incentive for investing
- Range of investment choice
- High limit on total account contributions
- Low required monthly contributions

Feature Arizona could benefit by adding:

- Assurance of quality customer service

Arizona has five of six important features—Of the six important features, auditors found that Arizona's program has the following five:

- **Low fees and expenses for accountholders**—It is important that fees and expenses remain low, as high fees and expenses decrease investment gains. The provider can pay Arizona's $10 application fee, and currently, all three providers pay this fee for their accountholders. However, some providers in Arizona's 529 program have not always offered products with low fees, which resulted in negative publicity for the program. The Commission took action in 2006 to remedy this issue and did not renew the existing contracts with Pacific Life and Securities Management and Research (SM&R), in part because the Oversight Committee was not satisfied with the progress these providers were making in lowering their fees. Instead, the Commission entered into new agreements that prohibited these providers from accepting new accountholders and allowed them to continue to manage their existing accounts only until November 19, 2007. Finally, in 2005, the Commission contracted with another provider, Fidelity, which had lower fees. Fidelity lowered its fees further in 2006 by eliminating its annual account maintenance fee. Also in 2006, Waddell and Reed reduced its fees on all of its portfolios.

1 These states with highly rated providers include Colorado, Ohio, Oregon, and Rhode Island, to whose representatives auditors spoke. Other states with highly rated providers include Utah, Georgia, South Carolina, and New Mexico. Auditors used provider ratings given on savingforcollege.com and Morningstar to identify states with highly rated providers.

Arizona providers' fees and expenses compare favorably with highly rated providers.

The impact of fees and expenses on investment returns can be significant. Although fees vary by investment provider and investment product, Fidelity and Waddell and Reed compare favorably overall with highly rated providers in regard to total fees and expenses paid by investors.

Arizona is one of only four states that allow a tax deduction for contributions to any state's 529 program.

- State incentive—States can encourage individuals to save for college through 529 programs by providing state incentives, such as state tax deductions. Nearly all states with highly rated providers offer some form of an incentive, typically either a tax deduction or a state match, for contributions made to a 529 plan. In June 2007, the Arizona Legislature passed, and the Governor signed, Laws 2007, Chapter 258, which enacted a tax deduction for contributions to any state 529 program. This law, which goes into effect January 1, 2008, allows a deduction of up to $750 for single filers, and up to $1,500 for those filing jointly. The law allows the deduction for tax years through December 31, 2012. By enacting a deduction for contributions to any state's 529 program, Arizona became the fourth state, along with Kansas, Maine, and Pennsylvania, to enact such a benefit.

- Range of investment choice—All of the states with highly rated providers that auditors interviewed offer a range of investment choices to meet the different investors' varying needs. Arizona's 529 program offers an expansive range of investment choices. Specifically, the Arizona 529 program's mutual fund providers offer 47 different portfolios, including age-based portfolios, static portfolios, and Fidelity's 15 index fund portfolios (see textbox, page 3, for definitions of these options). Arizona also offers a nontraditional CD as an additional investment option (see pages 16 through 17). These options allow accountholders to choose from a broad range of potential investment risk and returns based on their preferences and unique college savings needs. For instance, if a beneficiary is many years from entering college, accountholders may elect to invest in riskier portfolios, while gradually decreasing the portfolio risk as the beneficiary approaches college-age. By comparison, Ohio and Colorado, which both have highly rated providers, offer a total of 32 and 20 investment options, respectively.

- High limit on account contributions—High limits on account contributions allow participants to save a significant amount of tax-free money for higher education, which is important given that college costs continue to rise. Arizona has a relatively high contribution limit, which, as of August 2007, is $304,000 per beneficiary. This places the State in the top third of state 529 programs[1]. The nation's highest contribution limit is in Pennsylvania, where the limit is $344,000, while the lowest contribution limit is in Louisiana, where the limit is $224,465.[2] Approximately half of the states with highly rated providers had above-average contribution limits. When determining if additional contributions can be made, both principal and interest are counted. Once contributions and interest equal

1 Arizona's contribution limit is seven times the average 1-year undergraduate costs of the ten most expensive eligible independent institutions listed in the Independent College 500 (IC 500) index. As of August 2007, the limit was $304,000.

2 The State of Washington offers a different type of plan with a maximum contribution of $35,000. The Washington plan is a pre-paid tuition plan based on tuition and state-mandated fees at the most expensive public university in Washington.

the maximum contribution limit, no additional contributions may be made. However, the account balance can grow to any size as interest accrues.

- **Low required minimum contributions**—Low required minimum contributions ensure that the benefits of 529 programs can be shared by individuals of all income levels. The required minimum contribution for Arizona's 529 investors varies by investment provider, but is comparable to required minimums in other state programs with highly rated providers, particularly when investors are enrolled in monthly automatic deposits or payroll deductions (see textbox). For example, Ohio and South Carolina, which are states with highly rated providers, require minimum contributions ranging from $15 to $25 and $50 to $250, respectively. By comparison, New York's 529 program, which does not have a highly rated provider, requires a minimum contribution ranging from $15 to $1,000 to open an account, depending on which of its plans is selected.

Minimum Contributions

College Savings Bank—For lump-sum contributions, the initial contribution must be at least $250; under the automatic investment plan, contributions must be at least $100 per month via bank transfer or $25 per pay period via payroll deduction.

Fidelity—Monthly contributions must be at least $50, unless investor is in the automatic investment plan, where contributions may be as little as $15 per month or $45 per quarter.

Waddell & Reed—Under the automatic investment plan, initial contributions must be at least $50. There is no minimum amount for contributions made by payroll deduction.

Arizona's 529 program could better ensure quality customer service—Arizona's plan is missing one of the features associated with states with highly rated providers—ensuring quality customer service. The Commission does not require systematically collected, Arizona-specific information from its 529 program investment providers regarding customer satisfaction. Consequently, although commission staff reported that they occasionally receive phone calls from accountholders or other interested parties regarding the 529 program, the Commission has no way of assessing overall customer satisfaction when assessing the 529 program providers. However, according to officials in two other states with highly rated providers that auditors interviewed, those states conduct surveys with 529 program accountholders or require that investment providers supply information regarding customer service. For example, the Oregon 529 College Savings Network, which oversees Oregon's 529 program, reviews tape-recorded customer service phone calls from its providers' call centers for errors in product explanation and to understand the type of questions being asked by customers, which helps tailor marketing efforts. CollegeInvest, which oversees Colorado's 529 program, performs an annual customer satisfaction survey to ensure that the customer service that both CollegeInvest and the providers are offering is adequate and helpful, and to make sure there are no major problems with the plan.

The Commission has no way of assessing overall customer satisfaction.

Learning more about its providers' customer service would allow the Commission to improve its administration of the 529 program in two specific ways. First, customer satisfaction information would allow the Commission to oversee how providers treat their accountholders, such as how long callers to the providers' customer service centers must wait for help. Additionally, knowing the type of questions that customers are asking could help to hone the provider's marketing efforts, which would help to persuade more individuals to save for college. According to the Commission's executive director, the Oversight Committee is planning to ask the providers for customer satisfaction data and benchmarks beginning in 2008. The Commission should determine what customer service and customer satisfaction information it needs and require that providers or commission staff collect this information and provide it to the Committee. Further, the Oversight Committee should determine the best way to use this information in evaluating the providers. Finally, based on the Oversight Committee's determination, the Commission should add customer service benchmarks to its provider contracts to ensure that the standard of customer service evaluation is clear to the 529 program providers.

Commission offers nontraditional CD

The Commission has contracted with College Savings Bank to offer a nontraditional CD option that combines aspects of a traditional CD and of a prepaid tuition program. This nontraditional CD option is structured so that investors purchase "units" or partial units. One unit is equivalent to 1 year of college tuition, fees, and room and board at the CD's maturity rate. Investors pay more than the current cost of college to receive assurance that the future cost of college will be covered. The investment return of this CD varies based on the price, called a margin, set by College Savings Bank.

Commission's CD option works differently than a traditional CD—

Unlike a traditional CD, which gives an investor a set interest rate based on the amount of money invested and the CD's date of maturity, the Commission has contracted with College Savings Bank to offer a CD where the investor's return is based on the future cost of college. The CD is generally sold in units or portions of units, with a unit being equivalent to 1 year of college tuition, fees, and room and board at the CD's maturity date.[1] By guaranteeing that purchasing these units will allow the investor to pay for the future cost of college, the CD option operates like a prepaid tuition plan.

The CD's yield is the college cost inflation rate minus a defined percentage called a "margin."

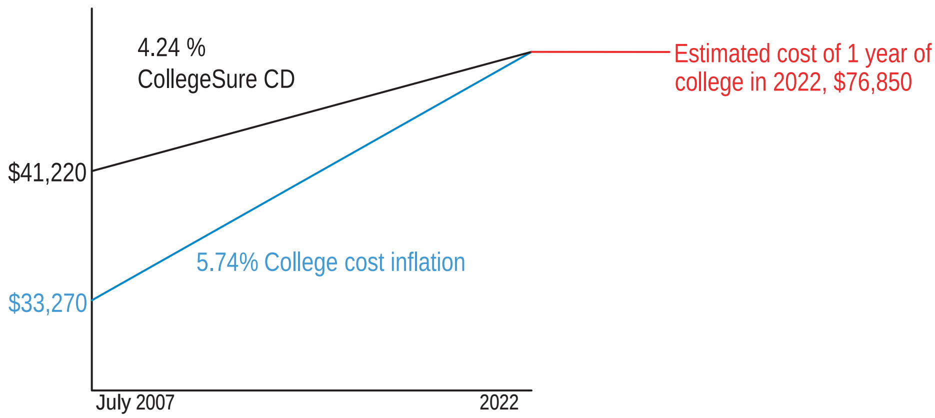
Like a traditional CD, the Commission's CD option provides an annual percentage yield (APY) to its investors. The APY is calculated by subtracting College Savings Bank's price—a defined percentage called a "margin"—from the College Cost Inflation Rate based on the Independent College 500 (IC 500) Index.[2] As of July 30, 2007, College Savings Bank charged a margin of 1.5 percent, meaning that the APY was 1.5 percent lower than the College Cost Inflation Rate.

1 According to College Savings Bank, all investments over $250 purchase a certain portion of a unit.

2 The IC 500 is an index published by the College Board, a higher education preparation and assistance nonprofit organization, and is designed to measure both annual averages and rates of change in the direct charges for most first-year, full-time students at the 500 independent colleges with no less than 15 percent of full-time undergraduate students living in college housing and the highest aggregate direct charges (for example, tuition and fees, books, and room and board).

As a consequence of the margin, investors in College Savings Bank's CD pay a higher price per unit than the current cost of college. If an investor purchased one unit at the interest rate available in July 2007 to cover 1 year of college costs in 2022, he or she would need to pay $41,220 at the time of investment, which is almost $8,000 more than the $33,270 that College Savings Bank estimates 1 year of college costs in July 2007 (see Figure 1). However, once the investment is made, the APY of the CD will rise and fall in parallel with college cost inflation (see Appendix, Figure 2, page a-i).

Figure 1: Amount That Must Be Invested as of July 2007 To Cover 1 Year of Estimated College Costs in 2022



Source: Auditor General staff analysis of information obtained from College Savings Bank's Web site, based on percentages and costs in effect as of July 30, 2007.

As of July 23, 2007, Arizona was one of only three state 529 programs that offer a CD option. One of the other two states, Montana, offers the same nontraditional College Savings Bank CD option offered by Arizona. The third state, Ohio, offers a CD option that is structured like a traditional CD, offering a specific, unchanging APY over a set time period.

CD's Annual Percentage Yield has varied—The APY performance of College Savings Bank's CD has varied since it was first provided in Arizona in 1999. Although the variation is partly related to changes in the IC 500, it is due mainly to changes in the margin set by College Savings Bank. In some years, the margin was set at zero, while in others, the margin was as high as 3 percent. Thus, while the IC 500 has increased by 5.35 to 5.74 percent annually from 2002 to 2006, the actual yield paid to investors could be as much as 3 percent below that range depending on when the CD was issued (see Appendix, Table 7, page a-vii).

Recommendations:

1. The Oversight Committee should continue to monitor the performance of all of the mutual fund options to ensure that they meet or exceed their benchmarks, and the Commission should take appropriate action as necessary based on the Oversight Committee's recommendations.

2. The Commission should determine what customer service and customer satisfaction information it needs, and require that providers or commission staff collect this information and provide it to the Oversight Committee.

3. The Oversight Committee should determine the best way to use customer service and customer satisfaction information in evaluating the providers.

4. Based on the Oversight Committee's determination, the Commission should add customer service benchmarks to its provider contracts to ensure that the standard of customer service evaluation is clear to the 529 program providers.

FINDING 2

Provider monitoring has improved, but should be further enhanced

The Commission and the Oversight Committee should build on recent improvements. First, although the Oversight Committee's monitoring of the Commission's investment providers has recently been enhanced, it could be improved further. In addition, the Commission should strengthen several contract provisions when it can renegotiate contracts with its 529 program providers. Finally, instead of having a contract provision to remit fees based on a percentage of new assets with only one of its three providers, as is currently the case, the Commission should include such a contract provision with all of its 529 program providers.

Oversight Committee has enhanced provider review process, but could make additional improvements

Although the Oversight Committee began conducting an annual provider review in 2006, its process could be improved. It can strengthen and standardize the methodology for evaluating providers.

Oversight Committee's provider review process now more comprehensive—Before 2006, the Oversight Committee's provider review process was limited to a review of providers' quarterly reports. This was problematic because, according to an Oversight Committee member, the Commission was unable to effectively address concerns with providers that were generating negative publicity. However, in 2006, the Oversight Committee began conducting an annual provider review meeting. For the 2007 meeting, providers submitted specific information, including an annual report, investment performance results, and marketing activities. The providers then appeared before the Oversight Committee to present information and address committee members' questions.

In 2006, the Oversight Committee began conducting an annual provider review meeting.

Auditors observed the March 2007 provider review and found that it was a comprehensive assessment. As part of the review, Oversight Committee members asked specific questions about a variety of issues, including investment return, fees, marketing, and a provider's new business relationship with a student loan provider. Some of the members' questions for representatives of Waddell and Reed and College Savings Bank necessitated additional meetings with these representatives. For instance, the Oversight Committee members questioned Waddell and Reed about its plan to expand investment offerings and the fees associated with those offerings. As a result Waddell and Reed later presented two proposals, including one that excluded planned offerings with the highest fees. The Oversight Committee members also expressed concern to College Savings Bank about its proposal to integrate its new business relationship with a student loan provider into its 529 program, and as a result, College Savings Bank representatives decided to limit this new relationship to non-Arizona 529 program activities.

In addition to the annual provider review process, the Oversight Committee continues to receive monthly reports from the providers detailing new accounts and assets under management. These reports are evaluated for troubling trends, such as a high number of withdrawals or account closings. Further, some of Arizona's 529 program providers told auditors that they regularly speak informally with the Executive Director regarding the 529 program.

Provider review methodology could be strengthened—Although the provider review process has been improved, the Oversight Committee could further strengthen its method of evaluating providers. It should implement a method for comprehensively evaluating provider performance by standardizing and documenting its methodology for reviewing providers, developing a way to assess the level of providers' partnership with the Commission, and exploring the feasibility of establishing standards for assessing providers according to statutory criteria. Specifically:

- **Standardize and document review methodology**—The Oversight Committee has a provider review comment form with components for Oversight Committee members to evaluate. This form guides Oversight Committee members to consider eight criteria, such as financial stability, fees, and minimum contribution amounts, that A.R.S. §15-1874(C) requires the Commission to consider in selecting financial institutions as 529 providers. However, members are not required to complete this form, the rating criteria are not prioritized or weighted, and the members are not required to rate providers on specific components regardless of whether or not they use the form. As a result, providers may not be consistently evaluated or evaluated on all of the eight components required by statute to be considered. By comparison, Ohio has standardized its provider evaluation methodology to systematically evaluate all of its providers against performance measures on a broad range of criteria, including investment management and fees. Oregon has begun moving toward doing such an evaluation, according to a representative of Oregon's 529 program.

Using a standardized review methodology is important when evaluating contractors, particularly when making decisions about whether to renew a contract. Although the Commission is exempt from the state procurement code when soliciting 529 providers, a National State Auditors Association report identifies using fixed, clearly defined, and consistent scoring; evaluating providers against a set of pre-established, standard criteria; documenting the award decision; and keeping supporting materials as best practices when procuring services.[1] The Oversight Committee uses the same process for evaluating providers whether their contracts are up for renewal or not. Consequently, using an evaluation and documentation approach that follows procurement best practices would be appropriate in its annual provider reviews.

- **Additional component**—The Oversight Committee should add provider partnership to the areas it formally reviews and establish criteria by which to assess this partnership. In Arizona, the Oversight Committee considers the level of partnership between the Commission and the 529 program providers to be an important component of its providers' overall performance. According to the Executive Director of Oregon's 529 program, Oregon also considers the level of partnership between the state and the 529 program providers, but has not set criteria for assessing partnership in its contracts. (See Finding 1, pages 11 through 18, for additional information regarding customer service.)

Partnership with Commission is an important performance component.

In addition to standardizing and documenting its review methodology and adding partnering to the areas it considers, the Oversight Committee should explore the feasibility of establishing qualitative or quantitative standards for assessing providers according to the statutory criteria. For example, the Oversight Committee may find that it can establish quantitative standards for evaluating providers' fees, as Ohio has done for its 529 program. Alternatively, it may find that qualitative standards would be more appropriate for evaluating other criteria such as the providers' plans for promoting the program. The Oversight Committee should then incorporate these standards, as appropriate, into its methodology for reviewing providers.

Commission should strengthen contract provisions

When provider contracts can be renegotiated, the Commission should strengthen the contracts in several ways.[2] Specifically:

- **Provide for account transition in the event of a provider termination or non-renewal**—In the Commission's current contracts with its providers, there is no

1 National State Auditors Association. *Contracting for Services: A National State Auditors Association Best Practices Document*. Lexington, KY: National State Auditors Association, 2003.

2 Contracts with Fidelity and College Savings Bank come up for renewal in 2008. The contract with Waddell and Reed comes up for renewal in 2009.

requirement for providers whose contracts are terminated or not renewed to transfer the accounts to a new provider in a way that does not impose additional costs on the accountholders. A.R.S. §15-1874 provides that if the Commission terminates a provider's contract, it must take custody of accounts and seek to promptly transfer them to another provider with investment instruments as similar as possible to the original investments. However, the transition from a terminated provider is complex. For example, some accountholders may have automatic payments set up for their 529 plan investments, and some investments may have built-in fees for early withdrawal. In Oregon, provider contracts include requirements related to making an orderly transition in the event of termination, and Oregon credits this contract language with ensuring the smooth transition of providers in 2003.

In 2006, the Commission faced the need to transition accounts from two providers, Pacific Life and SM&R, whose contracts were not renewed. In this situation, some accountholders might have been required to pay sales charges on the accounts that would be liquidated and transitioned to a new provider. In part because of this possibility, the Commission entered into new 1-year contracts with Pacific Life and SM&R after the previous contracts ended, allowing these providers to manage the funds of their accountholders until the accounts could be transitioned to new providers.

To avoid future situations where accountholders could incur costs because of a provider's termination, the Commission reported that the Oversight Committee is considering recommending that the Commission adopt a policy disallowing the sale of mutual fund shares carrying sales charges that must be paid when account shares are sold. If the Commission does not adopt such a policy, it should establish contract provisions requiring that, in the event of a provider's termination or nonrenewal, the provider must transfer the accounts to a new provider in a way that does not impose additional costs on the accountholders.

- Require that all 529 providers submit audited financial statements to the Committee—The Commission's contracts with Fidelity and Waddell and Reed require that they provide audited financial statements of their 529-related areas, which would determine any deficiencies in the accounting practices related to the Arizona 529 program, but does not require it of College Savings Bank. Waddell and Reed did not comply with this requirement in 2006. However, College Savings Bank provided audited financial statements for 2006 despite not being required to do so. The Commission should contractually require all of its providers to submit audited financial statements and ensure that these statements are submitted as required.

  Additionally, the Commission should consider requiring that providers that undergo internal control reviews submit the results to the Commission. Federal law requires internal control reviews for publicly held companies, such as

Waddell and Reed, and the other providers may obtain internal control reviews for other purposes. Because these reviews can highlight weaknesses before they become problems, the Commission may want to receive the results of such reviews in order to ensure that its providers take appropriate action to address any identified weaknesses.

- **Require that 529 providers undergo a review of their information technology (IT) security**—The Commission should require that its providers undergo a review of their IT security efforts to ensure that they have adequate controls and safeguards over accountholders' personal information, and report these results to the Oversight Committee. Oregon's 529 program is already performing a similar type of review in which the providers undergo a biennial due-diligence review that evaluates the effectiveness of the provider's controls and IT security. The Commission should also require that providers take appropriate action if the reviews show IT security weaknesses and report the outcome to the Oversight Committee.

Commission does not have asset-based fee provisions with all providers

The Commission has a provision in its contract with Waddell and Reed to receive a fee based on a percentage of the assets invested in Waddell and Reed accounts opened on or after November 18, 2006. However, the Commission does not have similar provisions in its other providers' contracts.[1] Fees derived from similar agreements are an important source of monies in Colorado, Ohio, and Oregon, and if the Commission enters into such fee agreements with its other providers, the monies could provide additional services such as assistance from attorneys with legal expertise in securities.

Under A.R.S. §15-1873(A)(6), the Commission is required to charge fees for any agreements, contracts, or transactions related to the 529 program. This requirement applies to the Commission's imposition of fees on all providers. The Commission plans to include a contractual asset-based fee provision when contracts with Fidelity and College Savings Bank can be renegotiated. The Commission should continue its efforts to add an asset-based fee provision to its contracts with Fidelity and College Savings Bank, when the contracts can be renegotiated.

Additionally, although an asset-based fee contract provision with Waddell and Reed is in place, the Commission has not yet promulgated rules governing the acceptance and use of the monies. The Commission was advised by its Attorney General representative that it should not accept these monies until it has promulgated administrative rules regarding asset-based fees. Therefore, the monies resulting from

The Commission does not have rules in place to accept revenue-sharing monies.

1 Under the contract provision, Waddell and Reed will make monthly payments to the Commission, calculated at an annual rate of 0.15 percent of the average value of assets. The average value is calculated monthly by adding the aggregate asset value as of the first business day of the month and as of the last business day of the month, and dividing the sum by two.

this agreement have been set aside by Waddell and Reed since November 19, 2006, and according to the Commission will not be given to it until administrative rules are in place.[1] The Oversight Committee has been working on revisions to its rules since fall 2006, but the rules have not yet been adopted. According to the Commission's Executive Director, as of June 27, 2007, these rules were under review by the Attorney General's Office. If the Commission decides to maintain its asset-based fee contract provision with Waddell and Reed, it should ensure that these rules are adopted quickly to allow the Commission to use these monies. Additionally, the Commission should ensure that these rules only allow the monies to be used for expenses related to the 529 program.

Recommendations:

1. To enable the Oversight Committee to provide more complete and effective oversight of the Arizona 529 program providers, the Committee should:

    a. Standardize its review methodology, including documenting its consideration of the eight factors required by A.R.S. §15-1874(C); and

    b. Add provider partnership to the areas it formally reviews, and establish criteria by which to assess partnership.

2. The Oversight Committee should also:

    a. Explore the feasibility of establishing qualitative or quantitative standards for assessing providers according to the statutory criteria; and

    b. Incorporate those standards, as appropriate, into its methodology for reviewing providers.

3. When its 529 provider contracts can be renegotiated, the Commission should strengthen the language in the contracts to require:

    a. If the Commission does not adopt a policy disallowing the sale of mutual fund shares carrying sales charges that must be paid when account shares are sold, in the event of a provider's termination or nonrenewal, the provider must transfer the accounts to a new provider in a way that does not impose additional costs on the accountholders;

    b. All providers to submit audited financial statements to the Oversight Committee;

[1] Waddell and Reed and the Commission reported that total monies due to the Commission under the asset-based fee contract provision were approximately $16,000 as of June 30, 2007.

    c. Providers to undergo a review of their information technology security, take appropriate action if the reviews identify any weaknesses, and report the outcome to the Oversight Committee; and

    d. Providers to take appropriate action if the reviews show IT security weaknesses, and report these results to the Oversight Committee.

4. When renegotiating its 529 provider contracts, the Commission should consider adding a requirement that providers that have undergone an internal control review submit the results to the Oversight Committee.

5. The Commission should ensure that it includes an asset-based fee provision in its contracts with Fidelity and College Savings Bank when the contracts can be renegotiated.

6. The Commission should ensure that:

    a. Rules governing asset-based fees are adopted to allow the Commission to use these monies; and

    b. These rules allow the monies to be used only for expenses related to the 529 program.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2954, the Legislature should consider the following 12 factors in determining whether the Commission for Postsecondary Education (Commission) should be continued or terminated:

1. **The objective and purpose in establishing the Commission.**

   The Commission was established in 1974 and has a variety of responsibilities. The Commission was created in 1974 by executive order. The Commission was created to fulfill a requirement of the federal Education Amendments of 1972 that a postsecondary commission be created to make states eligible for grant funding under the 1972 law. In the years since its creation, the Commission has been either under the supervision of the Arizona Board of Regents or an independent entity. A 1991 executive order made the Commission independent of the Board of Regents, and it has remained so since that time.

   The Legislature codified the Commission's responsibilities in statute through Laws 1994, Chapter 298. Some of these responsibilities have remained constant, including the administration of the LEAP program and the provision of information to the public regarding postsecondary education opportunities. However, the statutes for the Commission have also been modified in a number of ways. The most notable changes include giving the Commission administrative responsibilities for the Private Postsecondary Education Student Financial Assistance Program (PFAP) created in 1996, for the 529 program that was created in 1997, and for the Postsecondary Education Grant (PEG) program created in 2006.

2. **The effectiveness with which the Commission has met its objective and purpose and the efficiency with which it has operated.**

   The Commission has been generally effective in administering the Arizona 529 program. For example, as discussed in Finding 1 (see pages 11 through 18), the Commission has worked to lower fees paid by investors in the 529 program. The Commission decided not to renew the contracts of two providers, Pacific Life and Securities Management and Research (SM&R), in part because of these providers' high fees. The Commission's Oversight Committee has also worked with Waddell and Reed to moderate the underlying fees on Waddell and Reed's new investments. Additionally, the Commission has been active in supporting legislation that was signed into law in June 2007 that will enact a tax incentive in Arizona for those individuals or couples who invest in 529 programs anywhere in the country. Finally, as discussed in Finding 2 (see pages 19 through 25), the Committee has improved its review of providers by inaugurating a more formalized review process in 2006.

The Commission and the Oversight Committee could enhance their effectiveness in protecting investors through improvements in several areas. Specifically, as discussed in Finding 1 (see pages 11 through 18):

- The Oversight Committee should continue to monitor providers' investment performance, and the Commission should take appropriate action as necessary.

- The Commission should determine what customer service and customer satisfaction information is needed and require that providers or commission staff collect this information and supply it to the Oversight Committee. Then, the Oversight Committee should determine how this information will be used to evaluate the providers.

  Additionally, as discussed in Finding 2 (see pages 19 through 25):

- The Oversight Committee should standardize its methodology for reviewing its providers and add provider partnership to the areas it formally reviews.

- The Commission should adopt additional provisions in its contracts to ensure that if it terminates or does not renew the contract with providers that the accounts are transferred to new providers without additional costs to the accountholders.

- The Commission should include asset-based fee provisions in all of its providers' contracts when the contracts can be renegotiated.

In addition to being generally effective at administering the 529 program, the Commission has been effective in its administration of the LEAP, PFAP, and PEG programs. Through these programs, the Commission distributed 5,052 grants totaling $4,840,334 from July 1, 2006 to June 30, 2007. In addition, the Commission has operated efficiently by working quickly to institute the PEG program, which went into effect in September 2006, and began accepting applications in March 2007. The Commission's staff worked with representatives of schools whose students are eligible to receive PEG funding to structure the program effectively. For example, the Commission reports having received a loan of two IT executives from DeVry Institute and Collins College, institutions whose students are eligible to participate in the PEG program. These executives assisted the Commission in developing a technology plan for implementing the PEG program. The Commission has also hired three staff members between August 2006 and May 2007 to help with administration of the PEG program and other financial aid programs the Commission oversees.

3. **The extent to which the Commission has operated within the public interest.**

The Commission has operated within the public interest by operating programs that help provide financial assistance for students. It also operates in the public interest by engaging in outreach activities that provide information about postsecondary education. The Commission has also acted in the public interest through its financial support of the Arizona Minority Education Policy Analysis Center (AMEPAC), which produces studies relating to the state of minority education in Arizona.

The Commission's Web site serves the public interest by communicating to the public the activities that the Commission performs. For example, the Commission's Web site provides a College Savings Planner, which provides information on the cost of postsecondary education, includes a worksheet to assist in determining how much to save for college, and lists the features of different vehicles for college savings, including 529 programs. Additionally, the Commission's Web site provides information about the Commission's various financial aid programs and College Goal Sunday, as well as free downloads of AMEPAC reports.

Finally, the Commission has acted in the public interest by serving as a forum for discussion between all sectors of postsecondary education. The Commission includes members from all sectors of Arizona's postsecondary education: public universities, community colleges, private universities and colleges, and private technical and trade schools. At the Commission's meetings, these representatives provide the perspective of their own background in discussing commission matters.

4. **The extent to which rules adopted by the Commission are consistent with the legislative mandate.**

General Counsel for the Auditor General has reviewed an analysis of the Commission's rule-making statutes by the Governor's Regulatory Review Council (GRRC), performed at auditors' request, and believes that the Commission has not fully established rules required by statute. A.R.S. §15-1854(A) provides that the Commission shall establish eligibility criteria for PFAP, including financial need and academic merit; shall develop application forms, procedures, and deadlines; and shall select qualifying students each year for participation in the program. Although A.A.C. Title 7, Chapter 3, Article 4, addresses this program, these rules do not establish deadlines for application submission.

Auditors also found that the Commission should enact rules in three additional areas. First, the Commission needs to ensure that its 529 program rules are updated to allow it to receive and use asset-based fees from its program providers. Second, the Commission should ensure that the 529 program rules restrict the use of these fees to activities related to the administration of the 529 program. Finally, the Commission should develop rules related to the PEG program, which it had not begun as of June 30, 2007, and adopt those rules.

5. **The extent to which the Commission has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.**

The Commission appears to adequately encourage public input before adopting rules. Prior to the most recent modification of its rules in 2003, the Commission published proposed rules in the Arizona Administrative Register, and has made additional efforts to inform interested parties about proposed rules. Specifically, the Commission reported that it mails each potentially impacted Arizona educational institution notices about proposed rules and regulations.

The Commission has also complied with the open meeting law requirement to post its meeting notices with at least 24 hours' notice in the required locations. However, the Commission has not complied with the open meeting law requirement that it provide the Arizona Secretary of State's Office with the location that public meeting notices will be posted.

Additionally, the Oversight Committee may have violated open meeting law requirements during its March 22, 2007 and April 4, 2007, meetings. During those meetings, representatives of the Arizona 529 program providers, who were members of the public, were asked to leave the meeting prior to discussion and votes. The Attorney General's representative for the Commission has since recommended that the votes made at these meetings while members of the public were not in attendance be ratified. By ratifying the decisions, the Commission and Oversight Committee affirm the decisions made during the parts of the above meetings when open meeting law requirements may have been violated. These votes were ratified by the Oversight Committee and by the Commission at separate meetings on June 5, 2007.

6. **The extent to which the Commission has been able to investigate and resolve complaints that are within its jurisdiction.**

The Commission does not have investigative authority. However, according to the Commission's Executive Director, consumer complaints related to financial assistance programs that the Commission administers are investigated by staff members, and consumers are informed of the resolution of their complaints. If complaints are brought to the Commission that are unrelated to its responsibilities, the Commission's Executive Director reported that consumers are referred to the appropriate regulatory authority.

7. **The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under the enabling legislation.**

   This factor does not apply because the Commission's enabling legislation does not establish any authority that would require prosecuting actions. However, the Attorney General's Office is used to seek repayment of some forgivable loans, which occurs when the commission staff is unable to achieve a repayment plan for the outstanding funds. In addition, the Attorney General is the Commission's legal advisor.

8. **The extent to which the Commission has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandate.**

   The Commission has supported recent efforts in the Legislature to offer a tax incentive to Arizona residents who participate in the 529 program, and to make changes to the PEG program to increase its availability. Specifically:

   - In 2006 and 2007, the Commission supported proposed legislative changes that would provide a tax deduction to any Arizona taxpayer who contributed to any state's 529 program. In June 2007, the Arizona Legislature passed, and the Governor signed, House Bill 2784, which allows a tax deduction for contributions to any state 529 program. Laws 2007, Chapter 258, which goes into effect January 1, 2008, allows a deduction of up to $750 for single filers, and up to $1,500 for those filing jointly.

   - In 2007, the Commission also supported a legislative change that would expand eligibility for the PEG program. Laws 2007, Chapter 280, was passed by the Arizona Legislature in June 2007 and signed by the Governor in July 2007. This change expands the eligibility for the PEG program by removing the requirement that applicants must have graduated from an Arizona high school. In addition, the change added members of the military who are stationed in Arizona, and their spouses, to the list of eligible recipients.

9. **The extent to which changes are necessary in the laws of the Commission to adequately comply with the factors listed in the sunset law.**

   No legislative changes were identified during this audit.

10. **The extent to which the termination of the Commission would significantly harm the public health, safety, or welfare.**

    Terminating the Commission would likely pose no significant harm to the public health, safety, or welfare of Arizona citizens. However, if the Commission were terminated, its various functions, including the oversight of the 529 program and the PEG program, would need to be removed from statute or taken on by other entities. Additionally, terminating the Commission would remove the only state body that provides a forum for communication between all of Arizona's postsecondary education sectors. Finally, the Legislature would need to designate another agency in accordance with Section 1202 of the Education Amendments of 1972 to allow the State to receive financial assistance under Section 1203 and Title X of the law.

In 2006, the Arizona House considered HB 2710, which would have transferred the oversight of the 529 program to the State Treasurer. Auditors' analysis of information on state 529 programs' Web sites determined that as of June 2007, 26 of the 49 state and District of Columbia 529 programs were overseen by a state treasurer or by a state office charged to oversee the states' investments. Two programs are overseen by an entity that focuses on the investment of monies, but is not a state treasurer's office, such as the Bank of North Dakota. Nine of the 50 programs are run by agencies that focus solely on the 529 program, and the remaining 13 programs, including Arizona's, are run by an entity with general higher education responsibilities.

11. **The extent to which the level of regulation exercised by the Commission is appropriate and whether less or more stringent levels of regulation would be appropriate.**

    Since the Commission is not a regulatory agency, this factor does not apply.

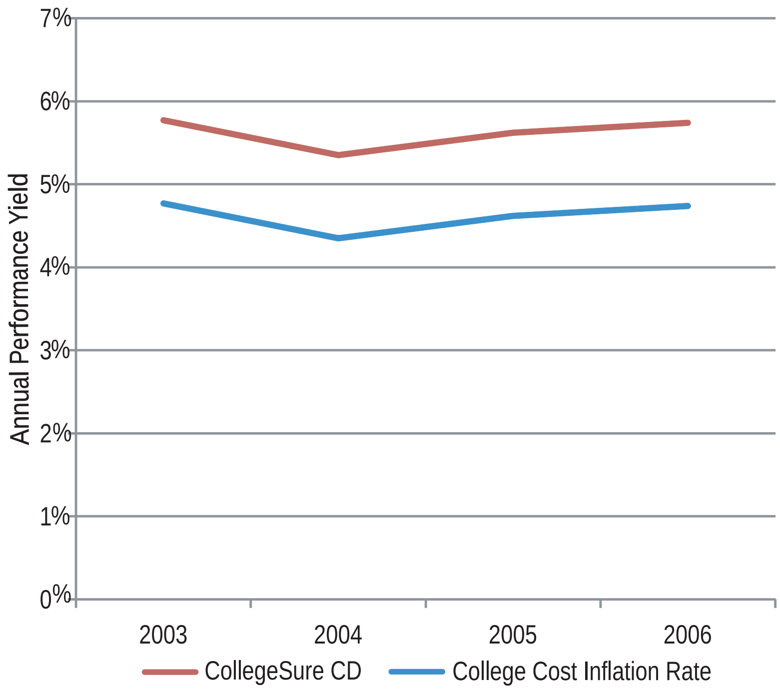
12. **The extent to which the Commission has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.**

    The Commission uses private contractors for a number of purposes. It contracts with publishers to print and disseminate the *College and Career Guide*. It has also used a private Web hosting company to provide its Web site to the public. Further, it reports that it has used private public relations firms to publicize some of its activities, such as its annual College Goal Sunday. Finally, the Commission contracts with private investment firms to provide various investment options as part of the Arizona 529 program and has used a private marketing firm to market that program.

    The audit did not identify any additional opportunities for the Commission to use private contractors, but identified a number of ways that the Commission could improve oversight of the 529 program providers (see Finding 2, pages 19 through 25).

APPENDIX

Figure 2: Annual Performance Yield of the CollegeSure CD Compared to the College Costs Inflation Rate Years Ended July 31, 2003 through 2006[1]



1 Rates shown for CollegeSure CD issued between August 3, 2002 and February 23, 2003. For CDs issued between these dates, the margin is consistently 1 percent. CDs issued after February 28, 2003, have a higher margin.

Source: Auditor General staff analysis of information in College Savings Bank's 2006 Annual Report provided to the Oversight Committee.

Table 3: Comparison of the PEG, LEAP, and PFAP Programs

	PEG	LEAP	PFAP
Number of Participating Institutions	30	47	16
Student Eligibility Criteria	A student must: • Meet one of the following conditions: o Graduate from an Arizona high school or its equivalency. o Be an Arizona resident for the past 12 months. o Be a member of the military stationed in Arizona, or the member's spouse or dependent. • Be enrolled at least part-time in a 4-year degree program in an accredited private postsecondary educational institution in Arizona. • Submit the free application for federal student aid. • Be lawfully present in the United States. • Meet the qualifications adopted by the Commission.	A student must: • Be a resident of Arizona. • Be enrolled or accepted for enrollment on at least a half-time basis in a qualified course or program at an eligible institution (see institutional eligibility criteria below). • Demonstrate a "substantial financial need." • Maintain good academic standing. • Not be in current default or repayment on a federal grant or loan.	A student must: • Be enrolled as a full-time student at an eligible institution (see institutional eligibility criteria below). • Have a demonstrated financial need. • Agree to reimburse the total amount of PFAP awards if he or she fails to receive a baccalaureate degree within 3 years after receipt of the initial PFAP award. • Have earned an associate's degree from a community college in Arizona.
Is Award a Grant or a Forgivable Loan?	Forgivable Loan	Grant	Forgivable Loan
Maximum Award	• Full-time students receive $2,000 annually for a maximum of 4 calendar years. • Amount for part-time students taking at least 6 hours is pro-rated based on hours enrolled.	• $2,500 for the year. • A student's initial award can be increased so long as the total awards for a program year do not exceed $2,500. • The amount of the award is made by a participating institution's financial aid office based on students' financial need and whether the program year award limit has been reached.	• $1,500 for full-time students for an award year. • $750 for full-time students for half an award year. • Maximum student can receive is $3,000. • Awards to new students are made in order of receipt of completed applications.

	PEG	LEAP	PFAP
Institution Eligibility Criteria	A nationally or regionally accredited private postsecondary educational institution in Arizona that awards 4-year baccalaureate degrees.	• Arizona postsecondary institutions that are public, non-profit, or proprietary. • Admits students who, at least, are above age of compulsory attendance and can benefit from training offered. • Is certified as eligible and has a valid Program Participation Agreement from the U.S. Department of Education. • For public and non-profit institutions: o Must be accredited by a nationally recognized accrediting agency or association. If they are not accredited, they can meet this requirement if they can show accreditation will be given in a reasonable period of time. o Must provide an educational program for which it awards an associate, baccalaureate, graduate, or professional degree. • For proprietary institutions: o Must provide at least a 6-month or 600-clock-hour training program to prepare students for gainful employment. o Must have offered training programs for 24 consecutive months.	Any private postsecondary institution: • Licensed to provide baccalaureate degrees in Arizona by the Arizona State Board for Private Postsecondary Education. • Accredited by an accrediting body recognized by the United States Department of Education.
Funding	State General Fund	LEAP funding comes from the federal government, the State General Fund, and participating institutions. Also, each institution is required to contribute an amount equal to the state contribution.	State General Fund
Administrative Expenses	$200,000 from legislative appropriation	Paid from institutional funds, and in fiscal year 2007 cannot exceed 12 percent of funds.	No more than 10 percent of total funds can be used.
Total Amount Awarded Fiscal Year 2006	NA	$2,808,172	$116,333
Total Grant Awards Fiscal Year 2006	NA	3,691	90
Total Amount Awarded for Fiscal Year 2007	$1,834,777	$2,855,382	$150,175
Total Grant Awards Fiscal Year 2007	1,077	3,874	101

Source: Auditor General staff analysis of A.R.S. §§15-1854 and 1855; Arizona Administrative Code R7-3-301 through 309, and R7-3-401 through 405; Laws 2007, Chapter 280; the Joint Legislative Budget Committee's *Fiscal Year 2007 Appropriations Report;* the Commission's 2006 Annual Report; and information provided by commission staff.

Table 4: Performance of Waddell and Reed's Arizona 529 Program Portfolios Versus Benchmarks As of April 30, 2007[1]

Portfolios	Average Annual Total Investment Returns[1] 1 Year	3 Years	5 Years	Since Inception in 2001
Waddell and Reed InvestEd Growth	10.58%	12.63%	9.08%	9.11%
80% S&P 500 and 20% Citigroup BIG Benchmark[2]	13.67	10.69	8.12	7.96
Waddell and Reed InvestEd Balanced	10.15	10.39	7.73	7.58
60% S&P 500 and 40% Citigroup BIG benchmark[2]	12.11	9.14	7.5	7.37
Waddell and Reed InvestEd Conservative	6.86	4.84	3.84	3.72
80% Citigroup BIG and 20% S&P 500 Benchmark	8.98	6.04	6.04	5.85

1 According to Waddell and Reed, average annual total investment returns for the Waddell and Reed investment portfolios do not include the effect of sales charges, but do include the effect of fund expenses charged by Waddell and Reed.

2 Waddell and Reed uses a blended benchmark composed of the S&P 500 and Citigroup BIG to evaluate its portfolios. The S&P 500 is a commonly used stock index, and the Citigroup BIG is a commonly used bond index.

Source: Auditor General staff analysis of information provided by Waddell and Reed staff.

Table 5: Performance of Fidelity's Arizona 529 Program Actively Managed Investment Portfolios Versus Benchmarks As of April 30, 2007

Portfolios	Average Annual Total Investment Returns[1] 1 Year	Since Inception in 2005 through April 30, 2007
AZ 100% Equity Portfolio	12.68%	15.71%
AZ 100% Equity benchmark[2]	15.34	16.56
AZ 70% Equity Portfolio	11.43	12.53
AZ 70% Equity benchmark[2]	13.21	13.13
AZ College Portfolio	6.94	5.67
AZ College benchmark[2]	7.61	6.16
AZ Conservative Portfolio	5.64	3.57
AZ Conservative benchmark[2]	5.82	4.14
AZ Portfolio 2006	7.18	6.22
AZ Portfolio 2006 benchmark[2]	7.96	6.78
AZ Portfolio 2009	8.00	7.58
AZ Portfolio 2009 benchmark[2]	9.08	8.15
AZ Portfolio 2012	8.87	9.12
AZ Portfolio 2012 benchmark[2]	10.23	9.77
AZ Portfolio 2015	10.05	10.93
AZ Portfolio 2015 benchmark[2]	11.66	11.58
AZ Portfolio 2018	11.31	12.62
AZ Portfolio 2018 benchmark[2]	13.07	13.04
AZ Portfolio 2021	12.07	14.10
AZ Portfolio 2021 benchmark[2]	14.17	14.68
AZ Portfolio 2024	12.71	14.77
AZ Portfolio 2024 benchmark[2]	14.84	15.30

1 Total investment return includes interest, capital gains, and dividends, and the effects of fund expenses.

2 The benchmarks were provided by Fidelity.

Source: Auditor General staff analysis of information provided by Fidelity staff.

Table 6: Performance of Fidelity's Arizona 529 Program Index Investment Portfolios Versus Benchmarks As of April 30, 2007

Portfolios	Average Annual Total Investment Returns[1] Since Inception in 2006 through April 30, 2007
Arizona 100% Equity Index	10.00
SEC AZ 100% Index benchmark[2]	10.44
Arizona 70% Equity Index	8.50
SEC AZ 70% Index benchmark[2]	8.41
Arizona College Index	4.30
SEC AZ College Index benchmark[2]	4.48
Arizona Conservative Index	3.00
SEC AZ Conservative Index benchmark[2]	3.21
Arizona 2006 Index	4.90
SEC AZ 2006 Index benchmark[2]	4.78
Arizona 2009 Index	5.70
SEC AZ 2009 Index benchmark[2]	5.63
Arizona 2012 Index	6.50
SEC AZ 2012 Index benchmark[2]	6.58
Arizona 2015 Index	7.50
SEC AZ 2015 Index benchmark[2]	7.53
Arizona 2018 Index	8.20
SEC AZ 2018 Index benchmark[2]	8.44
Arizona 2021 Index	9.60
SEC AZ 2021 Index benchmark[2]	9.20
Arizona 2024 Index	10.20
SEC AZ 2024 Index benchmark[2]	9.55
Arizona International Treasury Index	3.70
SEC AZ International Treasury benchmark[2]	3.82
Arizona International Index	15.80
SEC AZ International Index benchmark[2]	16.62
Arizona Spartan 500 Index	9.30
SEC AZ Spartan 500 benchmark[2]	8.69
Arizona Total Market Index	9.40
SEC AZ Total Market benchmark[2]	9.37

[1] Total investment return includes interest, capital gains, dividends, and the effects of fund expenses.
[2] The benchmarks were provided by Fidelity.

Source: Auditor General staff analysis of information provided by Fidelity staff.

Table 7: Annual Performance Yield (APY) for CollegeSure CD Years Ended July 31[1]

CD Issue Dates	Margin[2]	Annual Performance Yield[1] Years Ended July 31 2002	2003	2004	2005	2006
11/1/97 - 8/2/02	0.00%	5.50%	5.77%	5.35%	5.62%	5.74%
8/3/02 - 2/28/03	1.00%	N/A	4.77%	4.35%	4.62%	4.74%
3/1/03 - 8/1/03	2.00%	N/A	3.77%	3.35%	3.62%	3.74%
8/2/03 - 1/31/06	3.00%	N/A	N/A	2.35%	2.62%	2.74%
2/1/06 or after	1.50%	N/A	N/A	N/A	N/A	4.24%

1 Each CollegeSure CD pays interest on July 31 each year it remains outstanding, at an interest rate that may change, equal to the rate of college inflation, as measured by the change in the IC 500 minus the margin, subject to a minimum interest rate. Given a constant level of college inflation, each year's interest rate increases over the term of the CD. Consequently, the actual APYs in the above table are for CDs at the midpoint of their term to maturity.

2 The margin is deducted from the annual percentage increase in college costs, as determined by the IC 500, to arrive at the CD's percentage yield for each year. The margin can vary depending on when the CD was issued.

Source: Auditor General staff analysis of information in College Savings Bank's 2006 Annual Report provided to the Oversight Committee.

AGENCY RESPONSE

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Website: www.azhighered.gov

October 9, 2007

Debra K. Davenport
Auditor General
2910 North 44th Street, Suite 410
Phoenix, AZ 85018

Dear Ms Davenport:

As the Executive Director of the Arizona Commission for Postsecondary Education (ACPE), I respectfully submit the Commission's response to the Performance Audit and Sunset Review of the Commission submitted on October 1, 2007. The Commission commends the Auditor General's office for the thoughtful and careful examination of the Commission's operations, activities, and initiatives that began with the Executive Director's response to the Sunset Factors in August 29, 2006 and resulted in the revised preliminary report draft to which this response is directed.

Much of the detailed investigation for this audit centered upon the Arizona Family College Savings Program (AFSCP), also known as the Arizona 529 plan. Furthermore, all recommendations in this report are related to the Arizona Family College Savings Program. This Program is administered by the Commission as a part of its core responsibilities of providing student financial assistance programs to postsecondary education students and their families.

The Commissioners commend the Auditor General's Office for making recommendations that will enhance and improve Commission procedures, identifying the significant changes in both the Commission and the AFCSP that have taken place over the past few years, and recognizing the value and expertise provided for the AFCSP administration through the AFSCP Oversight Committee. The structure established in Statute for the Arizona Family College Savings Program provides for a ten-member Oversight Committee of financial experts in fields within and contiguous to the 529 plan industry. The Oversight Committee is charged with the responsibility of recommending to the Commission appropriate program managers, contract terms, and administrative improvements of the Arizona 529 plan. Several of the recommendations within this audit report allow the Oversight Committee to make the final determination of how recommendations should be implemented. Because of this recognition of the expertise of the Oversight Committee, the Commission is in agreement with all ten recommendations posed in the report.

The staff and Commissioner's appreciate the professionalism of your staff during the audit and their willingness to engage in dialogue to ensure accuracy and understanding. The Commission looks forward to continuing this process and implementing the recommendations contained in the report.

Sincerely,

Dr. April L. Osborn
Executive Director

Response of the Arizona Commission for Postsecondary Education

to the

Revised Draft Performance Audit and Sunset Review by the Office of the Auditor General

October 9, 2007

Submitted by Dr. April L. Osborn
Executive Director

TABLE OF CONTENTS

I. The Agency Mission is Outlined in Statute

ARS 15-1851 through ARS 15-1879 Defines the Program of Work for the Arizona Commission for Postsecondary Education

Because the Auditor General's Report was predominately focused on the role of the Arizona Commission for Postsecondary Education (ACPE) and its administration of the Arizona Family College Savings Program. The response to the Draft Performance Audit and Sunset Review will begin with an overview of the work of the agency as a whole and then address the two findings that were limited to the Arizona Family College Savings Program.

The Arizona Commission for Postsecondary Education has undergone significant changes since its last performance audit in November of 1997. The Commission was originally established within the Arizona Board of Regents (ABOR) and through legislative action taken in 1994 the Commission was permanently separated from ABOR.

This permanent separation was undertaken to allow the Commission to meet federal requirements for the administration of federal programs. Likewise, it provided the ability for the Commission to serve as a neutral, non-regulatory agency which serves all constituencies within the higher education system including community colleges, public universities, private colleges and universities, and vocational programs. The 1994 enabling legislation named a number of responsibilities to be undertaken by the Commission. Many of these ACPE responsibilities have remained constant over the past decade, including:

- administration of the Leveraging Educational Assistance Partnership grant (formerly SSIG),
- administration of the Paul Douglas Teacher Scholarship Program repayments and the ATIP repayment programs,
- provision of a forum for private and public postsecondary education institutions to discuss issues of mutual interest,
- provision of reports and the promotion of collaborative studies on issues of mutual interest for postsecondary education, and
- compilation and dissemination of information to the public regarding postsecondary education opportunities.

Over time the enabling statute for the ACPE was modified in a number of ways. The most notable changes required the ACPE to take on additional responsibilities of:

- administration of the Private Postsecondary Education Student Financial Assistance Program (PFAP) in 1996,
- administration of the Arizona Family College Savings Program (AFCSP) in 1997, including the initiation of the AFCSP Trust in 2005,
- administration of the Postsecondary Education Grant Program in the 2006 legislative session,
- administration of the Early Graduation Scholarship Grant Program in the 2007 session, and
- oversight of the Foster Youth Transition to Postsecondary Education Case Manager Program, also in the 2007 session.

In summary, many of the core areas of responsibility, as outlined in statute, for the Commission have remained constant since 1994. Over the past decade the legislature has required the Commission to assume additional administrative duties in student financial assistance with the addition of PFAP, the Arizona Family College Savings Program, the Postsecondary Education Grant Program, and the Early Graduation Scholarship Grant Program.

II. The Agency Mission is Addressed through a 5-Year Strategic Plan

Staff are Directed by a 5-Year Strategic Plan Developed by Commissioners

The work of the Arizona Commission for Postsecondary Education (ACPE) is guided by a 5-year strategic plan that focuses its staff and resources on the Commission's legislative mandates. The purpose of the plan is to ensure the activity of this small agency and its eight staff members is focused on the appropriate activities and initiatives in order to increase productivity and impact in the areas of its statutory authority. The Commission is comprised of 14 Governor-appointed representatives who are senior management in the various sectors of postsecondary education and two Commissioners named by position: the Executive Directors of the Arizona Board of Regents and the Arizona State Board for Private Postsecondary Education.

The Commissioners identified an agency mission of *expanding access and increasing success in postsecondary education for Arizonans.* Three goals were named to achieve this mission: (1) increase available student financial resources, (2) implement strategies to help students and their families plan, enter, and succeed in postsecondary education, and (3) provide a forum for all sectors of higher education to dialogue, partner, and problem solve issues of mutual interest. At the time of this performance audit, the Commission had just completed it third year of the 5 year plan and review of goals, performance, and outcomes as outlined in the plan.

In response to the Commissioner directed goals, the ACPE staff has identified efficient and effective administration of the financial assistance programs under their management as the primary strategy to achieve Goal 1. The second and third goals are supported through policy analysis and research, as well as by collaborative action led by ACPE task forces and participation in college access initiatives led by foundations, government, or non-profit entities with similar missions.

The strategies of efficient and effective administration and leveraging resources through collaboration and partnerships are born of necessity, as the agency received less than $240,000 of state general funds for agency operations in 2006-2007. This amount is only 51% of the total operational budget, while program administration fees, donations, and grants fund the balance of the operational budget of the agency.

III. Outcomes of Agency Activities and Initiatives

FY 2006-2007 Outcomes of the Arizona Commission for Postsecondary Education

Objective 1*:* Effective, efficient administration of student financial assistance programs under the ACPE

- Leveraging Educational Assistance Partnership (LEAP)

  $2.8M was disbursed to more than 4,000 low income students attending 47 postsecondary institutions including community colleges, public universities, and private colleges and universities in FY 2007 through the LEAP program.

- Private Postsecondary Student Financial Assistance Program (PFAP)

  $150,000 was disbursed to 101 students with financial need who graduated from Arizona community colleges and attended private colleges and universities to attain a baccalaureate degree in 2007.

- Postsecondary Education Grant (PEG) Program

  PEG program funds were released to the ACPE in November. Staff was hired, the program developed, technology was in place, and in the last three months of FY2007 $1.8M dollars were disbursed to 1,077 students seeking a baccalaureate degree from Arizona private colleges or universities.

- Repayment Programs

  Seventy-six students were in repayment for Paul Douglas and PFAP forgivable loans in FY 2007. Likewise, forty-five students were in process for repayment or have been turned over to the Attorney General's office for collection in that year.

- Early Graduation Scholarship Grant Program

  This new program is designed to provide an incentive to motivate high school students to graduate early and transition into a postsecondary educational experience. The EGSG Program is currently under development.

- Arizona Family College Savings Program

  More than 45,000 accounts were opened and more than $422 M was saved by families to pay for college expenses in the Arizona Family College Savings Program since 1999. The number of Arizona accounts increased 21.5% in FY 2007.

- Arizona Family College Savings Program Enhancements Have Been Implemented

  Program Restructuring A rigorous annual provider review process concluded in the non-renewal of two program providers (Pacific Life and Securities Management & Research).

  Professional money management is now provided by three experienced and trusted financial institutions

  College Savings Bank (Direct-sold CD)
  Fidelity Investments (Direct-sold Mutual Funds)
  Waddell & Reed (Adviser-sold multiple funds)

  College Savings Plan Network (CSPN) *Principles of Disclosure* is the standard *The Arizona Family College Savings Program* providers offering materials are required to meet. Review of provider materials and documentation are measured against these voluntary profession-identified standards for clarity and investor disclosure by the Arizona Commission for Postsecondary Education.

  A broad range of investment options are available**.** Fidelity Investments announced several enhancements to the Fidelity Arizona College Savings Plan including a new line of Index Funds portfolios, which are among the lowest cost in the 529 industry. In addition, Waddell & Reed has launched a new class Ivy Funds of shares giving financial advisers access to a wider range of choices more adaptable to individual needs as they work with their clients. College Savings Bank offers a FDIC insured Certificate of Deposit.

  Fees have been reduced. Waddell & Reed implemented fee reductions in the beginning of 2006 across all its age-based portfolios and converted all mutual funds Class B and Class C shares to the lower-cost Class A shares at no cost to the investors. Furthermore, Fidelity Investments eliminated its low-balance annual fee and reduced the initial investment minimums as well as the monthly contribution amount minimums for those accounts with automatic investment plans.

Objective 2: To provide information to parents and students to assist in college preparation, planning, transition, and success

- Arizona College and Career Guide

  15,000 copies of this publication which provides a comprehensive listing of all Arizona postsecondary institutions, programs offered, and tuition and fees were distributed to high school counselors, high school seniors, vocational rehab program administrators, postsecondary education professionals, and other parties of interest in FY 2007.

  13,000 visits were counted on the Arizona College and Career website that same year.

- Countdown to College

  800,000 copies of this 12-page insert detailing financial aid processes and opportunities and college-going information for families and students were distributed across the state on Sunday, February 4, 2007 in the *Arizona Republic*. This is a partnership effort with USA Funds.

- Web portal for college-going and financial assistance

  41,880 visits were counted for the Commission website. The site includes extensive information regarding student financial aid and instructions for completing the processes and meeting the deadlines for securing student financial aid.

- College Savings Planner

  2,000 copies of a 16-page college savings planning document, which describes and compares various savings vehicles families can use to save for college, were distributed to families and 13,140 downloads of the planner from the website took place in FY 2007.

- Rapid Guide to Student Financial Aid

  This pocket-sized laminated guide provides to high school juniors Arizona-specific information about federal, state, and local financial aid. This new initiative is being undertaken to assist students as they navigate the complex processes necessary to access the financial aid that is available. The Arizona Commission for Postsecondary Education plans to distribute 15,000 copies of this guide with the help of high school counselors in FY 2007-2008.

Objective 3: Serve as a forum to problem solve and seek opportunities across all sectors of public and private postsecondary education and through policy analysis and research to identify issues of common interest to the postsecondary education leaders.

- College Goal Sunday Program (statewide)

  This grant-supported program (1) provides timely information on the financial aid processes and encourages students to access the financial aid that is available to them, and (2) coordinates a statewide event for students and their families where they are assisted by more than 300 college financial aid professionals in completing the Free Application for Federal Student Aid (FAFSA). The FAFSA is the single form required to access nearly 95% of all financial aid. The FAFSA has been found by researchers to be more difficult to complete than the annual IRS income tax form.

  More than 2,800 parents and students attended the February 2007 event where more than 310 college financial aid professionals assisted them in completing the FAFSA.

  18,974 visits were counted on the College Goal Sunday website where information and line-by-line instructions are available for the public's use in completing the FAFSA on-line.

- Arizona Minority Education Policy Analysis Center (AMEPAC)

  This donation supported policy analysis center is housed within and supported by the staff of the ACPE. Published studies include

  The Road to Higher Education, 2006;

  Investing in Arizona's Future, 2005; and

  Minority Student Report 2007: A Snapshot of Arizona's Educational Achievement

- Developing Arizona's Human Capital Conference & Pathways to Higher Education Awards

  The 8th conference takes place on November 8 & 9, 2007 with a goal of providing a forum for discussion and planning for the improvement of the Arizona postsecondary education system.

  20 applications describing Arizona college access, transition, and success programs were received and 5 award winners were recognized at the 2006 conference as a means to publicize Arizona's best practices and encourage the initiation or the adoption of successful programs.

IV. Agency Response to Performance Audit Findings and Recommendations

Finding 1: Arizona's 529 Program Offers Most Features of a High Quality Program

Recommendation 1:

The Oversight Committee should continue to monitor the performance of all of the mutual fund options to ensure that they meet or exceed their benchmarks, and the Commission should take appropriate action as necessary based on the Oversight Committee's recommendations.

The Arizona Family College Savings Program (AFCSP) Oversight Committee places great importance in its responsibility to monitor the performance of all providers' investment options, both mutual funds and the Certificate of Deposit. As the Auditor General's office reported, this takes place through the quarterly reports from the vendors, an annual written report wherein vendors evaluate their own investments against benchmarks appropriate to their products, and the annual face-to-face interviews with representatives of each of the program manager representatives. Questions are asked and answered regarding performance at the time of the review of the written report, at the face-to-face interviews with providers by the Committee, and follow-up questions are asked when necessary after the interview. If answers are not satisfactory regarding investment performance following the report, interview, and questions, an on-going discussion regarding investment performance is initiated with the AFCSP staff leading the dialogue.

It is this rigorous and extensive annual performance review process that resulted in the non-renewal of the contracts of two of five providers in 2006. The process continues to be refined and adapted as necessary and investment performance is a critical factor in the annual review. The finding of the Auditor General is agreed to and the audit recommendation will continue to be implemented.

Recommendation 2:

The Commission should determine what customer service and customer satisfaction information it needs, and require that providers or commission staff collect this information and provide it to the Oversight Committee.

The Arizona Family College Savings Program Oversight Committee has been focused on customer satisfaction of account holders for some time. At the July 26, 2007 Oversight Committee meeting, Committee members again iterated the opinion that the best measures of customer satisfaction lie within the numbers of newly opened accounts, the numbers of accounts closed and rolled over, and growth of the assets in college savings accounts in each of the plans. This data has been a part of the review of the Arizona 529 plan by the Oversight Committee since its inception.

When the Arizona Family College Savings Program Annual Provider Review Process was established there was much discussion around the issue and the challenge of a common customer satisfaction measurement standard for the three widely varied financial products offered. The AFCSP includes program managers who provide a CD investment option, direct sold mutual fund offerings with application on the internet and guidance provided over the phone, and an advisor sold mutual funds option where advisors provide face-to-face financial advice to clients.

On July 26, 2007 the Committee added to the required Annual Provider Performance Review Report the submission of all customer service data collected by each program manager. The revised process was accepted by the Arizona Family College Savings Program Trustees at the August 15, 2007 Arizona Commission for Postsecondary Education meeting. Therefore, the February 2008 annual provider review report will require each of the three AFCSP program managers to submit all data currently collected regarding customer satisfaction, the benchmarks used for evaluation, and the measurement of results against each of these benchmarks.

The finding of the Auditor General is agreed to and the audit recommendation is being implemented.

Recommendation 3:

The Oversight Committee should determine the best way to use customer service and customer satisfaction information in evaluating the providers.

As stated in the response to Recommendation 2, the Oversight Committee will evaluate the data, benchmarks, and success measures offered by providers regarding their customer satisfaction data and benchmarks in their annual report in early 2008. The Committee will determine following the 2008 provider review process if any further information is needed, and if changes are necessary for the next provider review process to achieve the goal of adequately measuring customer satisfaction among these the three disparate vendors.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 4:

Based on the Oversight Committee’s determination, the Commission should add customer service benchmarks to its provider contracts to ensure that the standard of customer service evaluation is clear to the 529 program providers.

The advice of the Arizona Family College Savings Program Oversight Committee as outlined in the response to Recommendation 3 will be sought to determine the best way to hold providers accountable for customer service. Again, the diversity of products and the mode of delivery of the products (direct sold and advisor sold, on-line and via a call center) will require careful consideration and review by the Oversight Committee and the ACPE staff to determine if benchmarks are appropriate for each vendor. Likewise, the advice of the Attorney General’s office will be sought to determine if such benchmarks are appropriate to include in the negotiated contracts with current and future program managers. With the additional data collected, the Oversight Committee will make a determination regarding customer satisfaction benchmarks.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Finding 2: Provider Monitoring Has Improved, but Should be Further Enhanced

Recommendation 1:

To enable the Oversight Committee to provide more complete and effective oversight of the Arizona 529 program providers, the Committee should:

a. Standardize its review methodology including documenting its consideration of the eight factors required by A.R.S. {15-1874(C); and

b. Add Provider partnership to the areas it formally reviews, and establish criteria by which to assess partnership.

The Arizona Family College Savings Program Oversight Committee has developed and implemented a comprehensive Annual Provider Review Process that has served as a model for other states. This process is derived from the statutory requirements for evaluation included in ARS 15-1874 as sited in Recommendation 1. The Commission Executive Director presented the Arizona Annual (529) Provider Review Process at the July 14-17 *The Roadmap to Operational Excellence* conference held by College Savings Plan Network in New York, NY.

The presentation invitation resulted from recognition within the industry that Arizona has developed a successful method of evaluating varied financial products and diverse financial institutions. The Arizona review process is of interest nationally because in the very young 529 plan industry very few states began their programs with more than one vendor. Today, as many states are moving toward two-provider or multi-provider platforms, Arizona is considered a leader and therefore there is interest in Arizona's evaluation process. Most importantly, this evaluation process successfully guided the Commission's decision to terminate two program managers as they were deemed to be no longer meeting the needs of the State nor the families saving for college in the Arizona 529 Plan.

The AFCSP Annual Provider Review Process is modified annually as necessary to meet the changing state and 529 plan environments. The Annual Provider Review Process for 2008 was approved by the Arizona Commission for Postsecondary Education in August. It includes a partnership component as suggested in the Performance Audit Report. The Oversight Committee will refine the methods for the evaluation of this parameter throughout the coming years as they gather more data on this aspect of the relationship with financial institutions.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 2:

The Oversight Committee should also:

a. Explore the feasibility of establishing qualitative or quantitative standards for assessing providers according to the statutory criteria, and

b. Incorporate those standards, as appropriate, into its methodology for reviewing providers.

The AFCSP Oversight Committee intends to continue to improve the Annual Provider Review Process as it is used over repeated years. This will involve continuing to implement modifications that will enhance the process for the benefit of the state and families who invest in the Program. The intent is that it will become a more standardized process and that performance measures can be identified that can be used across products and years. However, the Oversight Committee understands the evaluation process will need to remain fluid as changes in products, providers, and the 529 plan environment will continue to occur rapidly in this very new industry. The evaluation to date has relied on both a qualitative and quantitative approach; however, the Committee will seek to move toward a more refined analysis for evaluation as it deems appropriate.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 3:

When its 529 provider contracts can be renegotiated, the Commission should strengthen the language in the contract to require:

a. If the Commission does not adopt a policy disallowing the sale of mutual fund shares carrying sales charges that must be paid when account shares are sold, in the event of a provider's termination or non renewal, the provider must transfer the accounts to a new provider in a way that does not impose additional costs on the accountholders.

b. All providers to submit audited financial statements to the Oversight Committee.

c. Providers to undergo a review of their information technology security, take appropriate action if the reviews identify any weaknesses, and report the outcome to the Oversight Committee.

d. Providers to take appropriate action if the reviews show IT security weaknesses, and report these results to the Oversight Committee.

It is the assumption of the Commission that sales charges named in Recommendation 2.a. are Contingent Deferred Sales Charges (CDSC) or back-end fees which are a part of certain investment products. As is indicated in the recommendation, the AFSCP Oversight Committee has considered this issue of these fees and has determined to exclude any products in their recommendation to the Commissioners that charge CDSC fees from future Arizona Family College Savings Program offerings.

Submission of audited financial statements to the Oversight Committee is currently a requirement of the Annual Provider Review report. It is also a requirement of two of three provider contracts. As suggested in the recommendation, a summary of the information technology security reviews for each provider will be added to the report required of each provider in the Annual Review Process to take place in a few months. The Commission is in agreement that any identified weaknesses will be required to be addressed by the provider.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 4:

When renegotiating its 529 provider contracts, the Commission should consider adding a requirement that providers that have undergone an internal control review submit the results to the Oversight Committee.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 5:

The Commission should ensure that it includes an asset-based fee provision in its contracts with Fidelity and College Savings Bank, when the contracts can be renegotiated.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Recommendation 6:

The Commission should ensure that:

a. Rules governing asset-based fees are adopted to allow the Commission to use these monies, and;

b. These rules only allow the monies to be used for expenses related to the 529 program.

Revised rules with language providing the aforementioned fees be used only for the expenses related to the administration of the Arizona Family College Savings Program have been submitted to the Attorney General's Office. The proposed revised rules state that the Commission may use the collected fees to pay for expenses related to the administration of the Arizona Family College Savings Program including but not limited to operating expenses, legal service expenses, and marketing expenses. The rule making process will be concluded at the earliest possible time.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

VI. Conclusion

The Arizona Commission for Postsecondary Education commends the Auditor General's Office for the careful examination of the Commission's operations, activities, and initiatives undertaken on behalf of the State. The Commission will take seriously the recommendations for improvement outlined in the report and is grateful for the fair and objective review provided of the work of the Commission.

Likewise, the Commissioners were pleased that the review of the overall work of the agency found that the Commission has operated in the public interest by providing programs that help provide financial assistance for students, engages in outreach programs that provide information about postsecondary education, and produces studies relating to minority education in Arizona.

The report also named the Commission website as a valuable source of information for the public about postsecondary education. And finally, the audit recognized the Commission for serving as the single state forum where all sectors of public and private education come together to discuss issues of mutual interest.

Likewise, the auditors looked extensively into the administration of the Arizona Family College Savings Program and found the Commission effective in its administration of the 529 plan. Furthermore, the audit report noted recent Commission actions resulting in reduced fees and an extensive annual provider review process.

The goal of the Commission is to continually work toward its mission and objectives of *expanding access and increasing success in postsecondary education for Arizonans*. This examination of Commission operations, activities and initiatives serves as a valuable resource for achieving these goals.

Performance Audit Division reports issued within the last 24 months

06-01 Governor's Regulatory Review Council
06-02 Arizona Health Care Cost Containment System—Healthcare Group Program
06-03 Pinal County Transportation Excise Tax
06-04 Arizona Department of Education—Accountability Programs
06-05 Arizona Department of Transportation—Aspects of Construction Management
06-06 Arizona Department of Education—Administration and Allocation of Funds
06-07 Arizona Department of Education—Information Management
06-08 Arizona Supreme Court, Administrative Office of the Courts—Information Technology and FARE Program
06-09 Department of Health Services—Behavioral Health Services for Adults with Serious Mental Illness in Maricopa County
07-01 Arizona Board of Fingerprinting
07-02 Arizona Department of Racing and Arizona Racing Commission
07-03 Arizona Department of Transportation—Highway Maintenance
07-04 Arizona Department of Transportation—Sunset Factors
07-05 Arizona Structural Pest Control Commission
07-06 Arizona School Facilities Board
07-07 Board of Homeopathic Medical Examiners
07-08 Arizona State Land Department

Future Performance Audit Division reports

Department of Economic Security—Division of Child Support Enforcement