U.S. Department of Labor

Office of Inspector General
Washington, D.C. 20210

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INFORMATION

MEMORANDUM FOR THE SECRETARY

Gordon S. Heddell

FROM: GORDON S. HEDDELL
Inspector General

SUBJECT: FY 2004 Independent Auditor's Report
Report No. 22-05-004-13-001

Attached is the Independent Auditor's Report on the Department's FY 2004 financial statements. We contracted with the independent certified public accounting firm of R. Navarro & Associates, Inc., CPAs (RNA) to audit these statements as of September 30, 2004, and 2003, and for the years then ended. RNA's opinion on the Department's consolidated financial statements is unqualified, and RNA's report on internal control notes no material weaknesses. I commend the Department for continuing to maintain this significant accomplishment.

RNA's report on internal control notes reportable conditions in the following areas: Federal Employees Compensation Act Medical Benefit Payments and Receivables and Continuing Eligibility for Compensation Payments; Information Technology General and Application Controls and Security; Procurement; Job Corps Real Property; Grant Accounting; Capitalized Assets; Unemployment Insurance Benefit Overpayments; and Implementation of Managerial Cost Accounting.

RNA's report on compliance with laws and regulations noted that the Department substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996. RNA noted no instances of noncompliance with other laws and regulations.

Attachment

cc: Samuel T. Mok
Patrick Pizzella

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CERTIFIED PUBLIC ACCOUNTANTS

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Independent Auditors' Report

To the Honorable Elaine L. Chao Secretary of Labor

The *Chief Financial Officers Act of 1990* (CFO Act) requires agencies to report annually to Congress on their financial status and any other information needed to fairly present the agencies' financial position and results of operations. To meet the CFO Act reporting requirements, the United States Department of Labor (DOL), a Department of the United States Government, prepares annual financial statements, which are subjected to audit.

The objectives of the audit are to express an opinion on the fair presentation of DOL's principal financial statements, obtain an understanding of the Department's internal control, and test compliance with laws and regulations that could have a direct and material effect on the financial statements.

Additionally, the objectives include expressing an opinion on DOL's compliance with requirements of the *Federal Financial Management Improvement Act of 1996*, based on an examination.

We have audited the consolidated balance sheets of DOL as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, financing, and custodial activity and the combined statements of budgetary resources for the years then ended. These financial statements are the responsibility of DOL's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements.* These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Relationship to the Single Audit Act

The financial statements for the years ended September 30, 2004 and 2003, include:

- costs for grants, subsidies, and contributions primarily with various state and local governments and nonprofit organizations in the amounts of $10.1 billion and $10.5 billion, respectively;

- costs for unemployment benefits incurred by state employment security agencies in the amounts of $41.7 billion and $53.4 billion, respectively;

- state employer tax revenue of $30.1 billion and $24.8 billion, respectively;

- net receivables for state unemployment taxes, reimbursable employers, and benefit overpayments of $1.1 billion and $.8 billion, respectively; and

- reimbursements from state, local, and nonprofit reimbursable employers for unemployment benefits paid on their behalf, in the amounts of $2.4 billion and $2.1 billion, respectively.

Our audits included testing these costs, financing sources, and balances at the Federal level only. Pursuant to a mandate by Congress, the examination of these transactions below the Federal level is primarily performed by various auditors in accordance with the Single Audit Act of 1984, as amended, and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. The results of those audits are reported to Federal agencies that provide direct grants, and each Federal agency is responsible for resolving findings for its awards.

Opinion on Financial Statements

In our opinion the aforementioned financial statements present fairly, in all material respects, the assets, liabilities, and net position of the DOL as of September 30, 2004 and 2003; and the net cost, changes in net position, budgetary resources, reconciliation of net cost to budgetary resources, and custodial activity for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Other Accompanying Information

Our audits were conducted for the purpose of forming an opinion on the consolidated and combined financial statements of DOL taken as a whole. The accompanying financial information discussed below is not a required part of the principal financial statements.

The supplementary information included in the Management Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections of the Performance and Accountability Report are required by the Federal Accounting Standards Advisory Board and OMB Bulletin No. 01-09. We have applied limited procedures, performed at the Federal level only, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the information. However, we did not audit the information and express no opinion on it.

The information included in the Annual Performance Report, Financial Performance Report, Management and Performance Challenges and the report appendices are presented for purposes of additional analysis. Such information has not been subjected to the auditing procedures applied in the audit of the consolidated and combined financial statements and, accordingly, we express no opinion on it.

Report on Internal Control

In planning and performing our audit, we considered DOL's internal control over financial reporting by obtaining an understanding of the Department's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the agency's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may, nevertheless, occur and not be detected. We noted certain matters, discussed in the following paragraphs, involving the internal control and its operations that we consider to be reportable conditions. However, none of the reportable conditions are believed to be a material weakness.

In addition, we considered DOL's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the agency's internal controls, determining whether they had been placed in operation, assessing control risk, and performing tests of controls as required by OMB Bulletin No. 01-02. The objective of our audit was not to provide assurance on these internal controls. Accordingly, we do not provide an opinion on such controls.

Finally, with respect to internal control relating to performance measures included in the Performance Report, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

Reportable Conditions

Current Year Reportable Conditions

Federal Employees Compensation Act (FECA) Medical Benefit Payments

The Employment Standards Administration's (ESA) Office of Workers' Compensation Programs (OWCP) has contracted with a third party, to perform medical bill processing for FECA claimants. The contractor began processing medical bills in September 2003.

Our FY 2004 audit found errors in the processing of medical bills. We tested 358 medical bills paid by the contractor during the period October 1, 2003 to March 31, 2004. Of these 358 bills, we found 35 bills (including duplicate bills related to 5 sample items), were not paid in the correct amount, including 24 overpayments totaling $282,577 and 11 underpayments totaling $34,658. These errors occurred because OWCP did not have a quality assurance and internal audit plan in place prior to implementation of the new system. Without adequate controls over the processing of medical bill payments, OWCP cannot ensure that amounts paid are correctly calculated in accordance with the fee schedules. As a result, medical providers have been overpaid and underpaid, resulting in the medical benefit expense being misstated.

Both prior to and in response to these results, management took steps to correct some of the weaknesses identified. We performed additional testing and found corrective actions taken by management resulted in a reduction in payment errors in the third quarter of the fiscal year.

We recommend that the Chief Financial Officer ensure that the Assistant Secretary for Employment Standards fully implements corrective actions that have been proposed or initiated by OWCP, and that the accounting records are adjusted to reflect identified misstatements. We also recommend that the Chief Financial Officer ensure that the Assistant Secretary for Employment Standards develops a quality assurance plan prior to migration to any significant system or system change.

Management anticipates full implementation of corrective actions in FY 2005, inclusive of policies for quality assurance plans for IT system migrations and changes.

FECA Medical Bill Receivables

We noted during our FY 2004 audit that OWCP and the contractor have not implemented a system to track and record medical bill overpayments (receivables) as required by JFMIP Benefit System Requirements. In addition to the $282,577 of overpayments we identified during our audit, OWCP and the contractor have identified overpayments during the course of the fiscal year, and the contractor has set up an ad-hoc method of tracking and collecting these overpayments.

Management indicated that a delay in the implementation of the new case management system resulted in a delay in the implementation of the Medical Bill Receivable feature. Without an adequate receivable recovery system, collection of receivables cannot be effectively managed and monitored, which could result in the failure to collect recoverable amounts. In addition, these receivables are not being captured in the Department's general ledger, resulting in an understatement of accounts receivable.

We recommend that the Chief Financial Officer ensure that the Assistant Secretary for Employment Standards develops and implements the receivable system for the identification, tracking, and reporting of medical benefit overpayments in accordance with JFMIP requirements and ensure that the accounting records are adjusted to reflect all current receivables.

Management indicated that the case management system, inclusive of the receivable system, will be deployed in FY 2005.

Information Technology (IT) Controls

The Department lacks strong application controls over the access to and protection of financial information. During our application controls testing of the DOLAR$, SPAMIS, FECS, Longshore, and PeoplePower applications that support the financial statements, we tested controls in the following areas: understanding of the application; application access controls; input controls; data processing controls, including exception reporting and problem tracking; and output controls. Specifically, we noted consistent weaknesses across the applications tested in the following application control areas:

- Application password settings
- User access
- Application segregation of duties
- User recertification
- Data input
- Key reports

These weaknesses occurred as a result of incomplete implementation and testing of policies and procedures, weak segregation of duties, guidance and implementation, system and/or resource limitations, and nonperformance of routine housekeeping and maintenance tasks to update systems and processes as the organization or business changes. These application control weaknesses, when taken together, increase the risk that an individual with access to one or more of the applications could input, process, and approve an erroneous transaction and not be detected.

We recommend the Chief Information Officer (CIO) ensure that the specific application control weaknesses identified during the audit and reported in the OCFO, ETA, and ESA Agency Audit reports, as well as the PeoplePower Application Controls Audit reports, are addressed by the individual agencies, and that the Office of the Chief Information Officer develop and/or enforce procedures and controls to address consistent or systemic application control weaknesses on current and future financial management systems.

The CIO generally agreed with our findings, and issued memorandums and policy statements requesting agency priority attention and action to strengthen application controls for DOL's major information systems.

Procurement

OASAM's procurement office processed approximately $296 million of the $622 million (48 percent) of new FY 2004 procurements for supplies and services. We judgmentally selected 10 procurement files for review that had activity during the fiscal year, and found that four of the files lacked sufficient documentation and were poorly organized. As a result, management was not able to demonstrate compliance with the sections of the FAR pertaining to contract competition for three contracts. Also, management could not demonstrate compliance with Federal Appropriations Law for one contract.

For the first procurement with a cumulative value of $10.3 million, the agency could not document the original scope or that modifications totaling over $10 million from July 1999 though February 2004 did not exceed the original scope. In addition, the file did not contain documentation that at least three schedule contractors were considered. In the second procurement, we found a Blanket Purchase Agreement (BPA) with multiple holders where the procurement file did not provide the rationale for expanding the scope of the work without providing other BPA holders the opportunity to bid on the work. In the third procurement, the contract file did not have any preaward documents or a task order with the contracting officer's signature approving the procurement. In the fourth procurement, the file did not include the rationale for using FY 2004 appropriations for FY 2005 services. The task order was awarded for new services that were continuing and recurring in nature, and should have been considered severable. Performance of these services did not begin in FY 2004 and DOL would not realize a benefit until such time as the services were provided.

The reasons for the lack of compliance with procurement policies and procedures were difficult to ascertain due to the change of procurement management and staff within OASAM. However, based on the condition of the files and the lack of critical procurement documentation, it was clear that files were not being maintained in accordance with existing procurement policies and procedures.

OASAM has recently changed procurement personnel and is in the process of adopting and implementing new policies and procedures, which it believes will ensure compliance with the FAR and DLMS and will improve record maintenance over this important function. Management provided various documents throughout the course of our audit as evidence that corrective actions have already been initiated, such as training plans, compliance forms, procurement checklists, etc.

We recommend that the Assistant Secretary for Administration and Management: ensures completion of policies that are currently being implemented to train staff, improve record maintenance, and establish consistent procurement practices designed to promote a better understanding and compliance with FAR and DLMS policies and procedures; ensures development of a monitoring process to ensure compliance with FAR and DLMS requirements; and analyzes FY 2004 obligations to determine the extent to which funds were obligated in the wrong year and takes necessary action to obligate the correct year.

Management concurred with the finding and recommendations, and indicated that the procurement office is prepared to make needed improvements.

Prior Year Reportable Conditions

Job Corps Real Property

DOL owns a significant amount of real property, which is capitalized and depreciated in the Department's accounting records, and is reported in the Department's financial statements. We previously reported that ETA did not sufficiently utilize the property subsidiary system, the Capitalized Assets Tracking and Reporting System (CATARS), as a complete property management system in accordance with the CATARS user guide. We also found that ETA did not establish sufficient controls to ensure that Job Corps capitalized real property was safeguarded and accurately reported in CATARS and the Department of Labor Accounting and Related Systems (DOLAR$) general ledger.

Management concurs with the need to improve controls over Job Corps real property and is implementing various corrective actions to ensure that both CATARS and DOLAR$ reflect accurate and complete property balances, and that assets are sufficiently safeguarded.

Federal Employees' Compensation Act (FECA) Compensation Payments

We previously reported that ESA's Office of Workers' Compensation Programs (OWCP) did not have adequate controls to ensure that current medical evidence is maintained in the case files to support the continuing eligibility of claimants. In our FY 2004 audit, we continued to note a high error rate where case files did not contain current medical evidence.

Management developed a corrective action plan that calls for the implementation of a new automated system in FY 2005, which will help ensure that medical evidence is obtained in accordance with program policy.

Information Technology (IT) Controls

The OIG previously reported the following deficiencies with regards to the Department's IT controls:

- The Department lacks strong logical security controls to secure the Department's data and information. Continuing weaknesses were identified with the Department's technical security standards and policies; logging, monitoring and response controls; system administration procedures; and the overall security framework.

- The Department has not coordinated comprehensive disaster recovery tests to ensure the Department's network and applications can be recovered in the case of a disaster. Testing conducted in FY 2004 identified that the Department's agencies were in varying stages of disaster recovery plan development and testing, and the Department had not coordinated disaster recovery efforts across all agencies or conducted a Department-wide test of disaster recovery plans. Given these conditions, there is a high likelihood that the Department could not recover its key operations in a timely manner in the event of a major disaster.

The CIO generally agreed with our findings and recommendations. The CIO has made a concerted effort to address these issues, and has several planned FY 2005 activities that build on its FY 2004 progress.

Accounting for Grants

The OIG previously reported the following deficiencies with regards to ETA's grant accounting:

- Various accounting errors were noted in amounts recorded for ETA's grants and contracts. In FY 2004, we continued to note errors at both the national and regional offices. For example, at the national level we identified that costs reported by grantees in the Enterprise Information Management System (EIMS) grant cost module did not agree to corresponding amounts recorded in DOLAR$, and that ETA was not sufficiently reconciling the cost information. At the regional offices, we noted errors in various Job Corps contracts selected for testing.

- Transfers of WIA funds between programs are not accounted for in ETA's accounting records.

- ETA’s grantees and contractors are often delinquent in submitting required cost reports. While efforts have been made to address this finding, our FY 2004 audit continued to note delinquent reporting.

ETA management plans to interface existing accounting systems in FY 2005, and anticipates that the interface will significantly improve the accuracy of grant costs recorded in DOLAR$, and has recently implemented other improvements to address these audit findings.

Capitalized Assets

The OIG previously reported that management’s capitalized asset tracking and reporting procedures do not ensure that disposals of capitalized assets are identified and reported in a timely and accurate manner, and that assets are adequately safeguarded against loss or theft.

We continued to note that certain agencies within the Department were merely removing items from CATARS that could not be found, rather than researching to find out the actual disposition of the missing assets. In addition, dispositions were not recorded timely but were recorded only after items were identified as missing in the physical inventory process.

Management agreed that further controls are necessary to ensure that property is properly managed and accounted for, and is working to correct these deficiencies.

Unemployment Insurance Benefit Overpayments

The OIG previously reported certain deficiencies in the internal controls over Unemployment Insurance (UI) benefit payments. Specifically, the OIG identified that UI overpayment data collected by the Benefit Accuracy Measurement (BAM) unit reflect significantly higher overpayments than those established as accounts receivable by the states’ Benefit Payment Control (BPC) system. We also found that there has been little change in the rate of overpayments (about 8.5 percent) since 1989.

Management contends that the actions outlined in its corrective action plan developed in response to this finding in prior years will eventually result in a significant reduction in the detectable, recoverable overpayment rate.

While we recognize that management has taken certain corrective actions, we noted that the actual UI benefit overpayment rate for 2003 did not reflect improvement. The UI benefit overpayment rates for 2003, 2002 and 2001 were 9.3 percent, 9.1 percent, and 8.2 percent, respectively. We conclude that additional evaluation of UI overpayments is necessary.

Management expects to see a positive impact on the rate of overpayments from the corrective actions taken to date, as states increase the use of tools made available by ETA, such as the use of new hire directories to detect claimants that have returned to work.

Implementation of Managerial Cost Accounting

The OIG previously reported that DOL was not in compliance with the requirements for managerial cost accounting (MCA) contained in Statement of Federal Financial Accounting Standards (SFFAS) No. 4. Specifically, DOL had not defined outputs for its operating programs nor developed the capability to routinely report the cost of outputs at the operating program and activity levels. Further, DOL did not adequately link cost information to performance measures at the operating program level for use in managing program operations on a routine basis or use managerial cost information for purposes of performance measurement, planning, budgeting or forecasting.

Management concurred with this finding, and developed a comprehensive plan to implement a Department-wide MCA system that complies with the requirements of SFFAS No. 4. As of the end of FY 2004, the implementation project directed by OCFO, with significant cooperation of agency personnel, has led to the successful development of cost models for substantially all of DOL's agencies and their major programs. OCFO recently certified the MCA system for processing and completed installation of the cost accounting software throughout each of the program agencies. In the near future, OCFO indicates that it will complete cost model documentation and provide final training to agency personnel. Management projects that all cost models will be updated with FY 2004 data and be operational during the second quarter of FY 2005.

We noted other matters involving the internal control and its operations that will be reported to the management of DOL in a separate letter.

Report on Compliance With Laws and Regulations Exclusive of the Federal Financial Management Improvement Act of 1996 (FFMIA)

The management of the DOL is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the FFMIA. We limited our tests of compliance to those provisions and we did not test compliance with all laws and regulations applicable to the DOL. Providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin 01-02.

Report on Compliance With FFMIA

We have examined DOL's compliance with the requirements of FFMIA as of September 30, 2004. These include implementing and maintaining financial management systems that substantially comply with: (1) financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger (SGL) at the transaction level. Management is responsible for DOL's compliance with these requirements. Our responsibility is to express an opinion on DOL's compliance based on our examination.

Our examination was conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. These standards include examining on a test basis, evidence about DOL's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination of DOL's compliance with specified requirements.

In our opinion, as of September 30, 2004, DOL substantially complied with the requirements of FFMIA.

This report is intended solely for the information and use of the management of the U.S. Department of Labor, the Office of Management and Budget, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

R. Navarro & Associates, Inc.

November 10, 2004