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FINANCIAL MANAGEMENT

Internal Control Weaknesses Leave Department of Education Vulnerable to Improper Payments

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our ongoing work on the Department of Education's payment processes, and how the existing internal control weaknesses we have noted thus far in our review make the Department vulnerable to improper payments. Improper payments include errors, such as duplicate payments and calculation errors; payments for unsupported or inadequately supported claims; payments for services not rendered or to ineligible beneficiaries; and payments resulting from fraud and abuse.

Since 1990, we have designated Education's student financial assistance programs as a high-risk area for waste, fraud, abuse, and mismanagement.[1] These programs remain at high-risk primarily because Education lacks the financial and management information needed to manage these programs effectively and the internal controls needed to maintain the integrity of their operations. Additionally, again this year Education was unable to obtain an unqualified audit opinion on its financial statements because significant financial management system and internal control weaknesses continue to impair the Department's ability to generate, analyze, and present reliable financial information. Given the billions of dollars in

[1] *Major Management Challenges and Program Risks: Department of Education*, (GAO-01-245, January 2001) and *High-Risk Series: An Update*, (GAO-01-263, January 2001).

payments made by Education each year to recipients nationwide and abroad, these known deficiencies in controls over financial reporting, accounting, and information systems raise the risk that erroneous or fraudulent payments could make their way through Education's processes without being prevented or detected.

Because of these risks, you requested that we audit selected accounts at the Department that may be particularly susceptible to improper payments. In response to your request, we have initiated a body of work designed to (1) identify Education's payment processes, (2) determine what internal controls exist over these processes, (3) assess whether the internal controls provide reasonable assurance that improper payments will not occur or will be detected in the normal course of business, (4) identify additional controls that should be implemented to provide reasonable assurance that improper payments will not occur, and (5) use various computer auditing techniques to identify potential improper payments made by Education during the period May 1998 to September 2000. This ongoing work, which builds upon earlier work done by the Education Inspector General (IG), includes testing of grant and loan payments to educational institutions and students, as well as payments to contractors, vendors and others in support of Education's operations totaling over $186 billion. We plan to use an automated approach, such as data base searches and other computer analyses, to identify unusual transactions and payment patterns and provide red flags that a payment may be improper.

My testimony today addresses the first phase of our work – assessing the internal controls over Education payment processes, as well as highlighting some of the findings from the fiscal year 2000 financial statement audit that was recently completed by an independent public accounting firm, Ernst & Young, under contract to the IG.

Let me first make a few comments on the importance of internal controls. Internal controls are a major part of managing an organization, serving as the first line of defense in safeguarding assets and preventing and detecting fraud, abuse, and errors. They consist of the plans, methods, and procedures used to meet missions, goals, and objectives. People are what make internal controls work. Internal control is not something to be built in at the end, but must be part of the daily fiber of management. The responsibility for good internal controls rests with all managers. The integrity and ethical values maintained and demonstrated by management plays a key role in the entire organization's ethical tone. By providing guidance for proper behavior, removing temptations for illegal, improper, or unethical behavior, and providing discipline when appropriate, management portrays a positive control environment, which is essential in achieving an agency's objectives.

During our analysis of the various payment processes,[2] we identified internal control weaknesses that sharply increase Education's vulnerability to improper payments. We classified the weaknesses into four broad categories, which are consistent with our *Standards for Internal Control in the Federal Government*:[3] (1) poor segregation of duties; (2) lack of supervisory review; (3) inadequate audit trails; and (4) inadequate computer systems' application controls. I would like to highlight some of the more significant weaknesses within each of these broad categories.

Poor Segregation of Duties

To reduce the risk of fraud and other improper payments, key duties and responsibilities associated with the payment process need to be divided or segregated among different people. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling the related funds.

[2] Consistent with your request to focus our audit on payment processes particularly susceptible to improper payments, we concentrated our efforts on the following payment processes: (1) grants and direct loans; (2) government purchase cards; (3) third party drafts; and (4) contract and purchase order payments. Grant and direct loans are processed by the Grant Administration and Payment System (GAPS), whereas the other payments are processed by the Financial Management System Software (FMSS).

[3] *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1), which was prepared to fulfill our statutory requirement under the Federal Managers' Financial Integrity Act, provides an overall framework for establishing and maintaining internal control and for identifying and addressing major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement.

Segregation of duties is one of the most fundamental internal control concepts.

However, we found that some individuals at Education can control the entire payment process for certain types of transactions. For example, some Education employees can issue hard copy checks, known as third party drafts, without involving anyone else. Currently 49 Education employees can request blank checks. We found that 21 of these individuals can also access the system, generate a payment without prior obligation, print and sign the check, and submit it to the payee. The Department is thus vulnerable to the possibility of individuals using third party drafts to pay for personal expenses, without any physical or system controls in place to prevent or detect such an occurrence. These drafts can be issued for up to $10,000 each and in fiscal year 2000, the Department reported issuing over 19,000 third party drafts totaling approximately $23 million.

We also found inadequate segregation of duties related to the electronic transfer of funds through the Federal Reserve Bank (FRB) network to a payee's bank account. Electronic fund transfers are used primarily to disburse grants and loans to schools, states, local education agencies and others. These payments totaled over a reported $181 billion from May 1998 to September 2000 – the period covered by our ongoing review. Although Education has a policy that prohibits the same individual from creating, certifying, and electronically transferring funds through the FRB, some Education employees are capable of doing this without involvement from anyone else. During a walkthrough of this payment process at the Office of the Chief Financial Officer (OCFO), a staff member told us that one snowy day last winter, when she was the only person in the office who works on these electronic fund transfers, she created, certified, and transmitted the payment files that day. There was no preventive control that limited the employee from performing all facets of the electronic fund transfers. Compounding this, because the Department does not have the appropriate follow-up controls in place, such as a requirement that supervisors document their post-review and approval of these types of transactions, the Department may not detect unauthorized FRB transfers.

Lack of Supervisory Review

Basic control activities, such as approvals, authorizations, verifications, reconciliations, and maintenance of documentation, are an integral part of an agency's accountability for government resources and achieving effective results, including the prevention and/or detection of improper payments. However, we found that Education has serious deficiencies in its process for reviewing and approving purchases made with Government credit cards – called purchase cards.

As of October 30, 2000, approximately 230 Education employees had government purchase cards in their names. According to a Departmental directive, Education's policy is to use government purchase cards for authorized purchases of expendable goods and services costing $1,000 or less, such as supplies not available from the GSA Customer Supply Center. Generally, Education employees are limited to charging up to $10,000 per month. Some employees have higher limits; we found that 36 individuals can charge $25,000 or more per month, and 2 of those employees can charge up to $300,000 in a single month. This policy also requires a person, designated as an approving official, to perform a review of cardholders' monthly statements prior submitting the statement for payment, to ensure that each purchase was made for official use and in accordance with established internal procedures. The approving official must sign the cardholders' monthly statements upon completion of the review process. In this case, the approving officials' review represents the principal internal control.

In order to determine whether Education is following its established policies, we selected 4 months of cardholder' statements to review for certain attributes, including approving official's signature. Of the 676 purchase cardholders' monthly statements that we have reviewed thus far, 141, valued at nearly $1 million, were not signed by an approving official indicating that the purchases were approved. We also noted that several of the types of purchases made by Education employees were items that could be used either for official business or for employees' personal needs, including computers, software, cell phones, and internet service. Education's own policy specifically lists computers as an item that should not be purchased with government purchase cards.

In June 2000, the Department of Defense (DOD) issued a Fraud Alert indicating that government purchase card use is increasing and along with the increase in spending levels there has been an increase in card abuse. Specifically, the Fraud Alert noted that some cardholders have conspired with unscrupulous vendors, while others have relied on the naïve trust of their supervisors who may have been negligent in their review of purchases. DOD has identified several instances involving the fraudulent use of government purchase cards.

During fiscal year 2000, Education employees made over $8 million in purchases using their government purchase cards. Without proper review and approval for these expenditures, the Department provides employees the opportunity to improperly use the government charge cards without detection.

Inadequate Audit Trails

Sound internal controls also include creating and maintaining adequate documentation providing a means to trace transactions back to their origination – in other words, generating "audit trails." While audit trails are essential to auditors and system evaluators, they are also necessary for day-to-day operation of the system because they allow for the detection and systematic correction of errors that arise. The Joint Financial Management Improvement Program's[4] Core Financial System Requirements state that federal financial systems must provide certain crucial audit trails, including trails to identify document input, change, approval, and deletions by originator.

Education refers to some of its audit trails as "trigger logs." For some payments, Education has a trigger log for documenting changes made to sensitive records, such as bank account routing numbers and payment histories for grants and administrative payments to schools. However, the Department lacks adequate trigger logs for other types of payments, including payments for contracting, third party drafts, and purchase cards, which according to Education totaled about $2 billion in fiscal year 2000.

[4]JFMIP is a joint cooperative undertaking of the Office of Management and Budget, the Department of the Treasury, the Office of Personnel Management, and the General Accounting Office working with operating agencies to improve financial management practices through the government. Agencies must follow JFMIP's federal financial management systems requirements in order to meet the requirements of the Federal Financial Management Improvement Act of 1996.

For example, changing a payee's mailing address or adding new vendors to the list of authorized vendors are sensitive transactions that must be closely controlled. Education officials acknowledged this weakness and told us that they are currently developing and implementing more effective controls.

Inadequate Information Systems' Application Controls

Rapid advances in information technology have highlighted the importance of internal controls related to modern computer systems. We have reported information systems security as a governmentwide high-risk area since 1997, most recently in January 2001.[5] In the past, the Education IG and Ernst & Young have reported serious information systems weaknesses. Later in my testimony I will highlight the information systems weaknesses Ernst & Young reported as part of the fiscal year 2000 financial statement audit. The Department places significant reliance on its automated systems to perform basic functions, such as making payments to grantees and maintaining budget controls. Consequently, continued weaknesses in information systems controls increases the risk of unauthorized access or disruption in services and make Education's sensitive grant and loan data vulnerable to inadvertent or deliberate

[5] *Major Management Challenges and Program Risks: A Governmentwide Perspective*, (GAO-01-241, January 2001).

misuse, fraudulent use, improper disclosure, or destruction, which could occur without being detected.

As part of our ongoing review, we identified control weaknesses related to the automated payment system's computer applications. As discussed in our Internal Control Standards, computer application controls help ensure that transactions completed through computerized applications are valid, properly authorized, and completely and accurately processed and reported. Application controls include (1) programmed control techniques, such as automated edits, and (2) manual follow-up of computer-generated reports, such as reviews of reports identifying rejected or unusual items.

One such application control in Education's system is an edit indicating that an invoice number had already been entered into the system, which is designed to avoid duplicate payments. However, our review of one of Education's procedure manuals disclosed that the Department has created a procedure that allows employees to circumvent this control. This manual instructs Education employees to add a suffix to the invoice/voucher number when the system indicates that an invoice number has already been used. For example, if invoice number 123 has already been entered into the system, an employee can add the letter "a" to this invoice number and issue another third party draft or other payment mechanism related to the invoice.

During our work, we found that it is common practice for Education employees to use multiple third party drafts to pay for purchases in excess of the $10,000 limit imprinted on the blank drafts. Education officials told us that they use multiple third party drafts to pay invoices greater than $10,000 primarily as a matter of convenience. For example, when it is necessary to research a transaction, Education officials told us that it is more convenient to have their own check numbers and copies of the checks on hand rather than having to review records of payments from Treasury. This process of circumventing a key control, combined with the lack of segregation of duties I described earlier, further exacerbates Education's vulnerability to making improper payments. In addition, this negates the control of limiting third party drafts to $10,000.

Another example of an application control weakness at Education is the Department's failure to use computer generated management reports that are currently available. For instance, Bank of America, Education's contractor for government purchase cards, provides several management reports for monitoring the card's usage. One report that we reviewed showed the Merchant Category Codes [6] (MCC) used by each cardholder. Approving officials could use this report to identify unusual or

[6]The Merchant Category Code relates to the types of supplies or services that a vendor provides. The MCC for the Government Purchase Card consists of 11 retail categories. Agencies have the ability to prohibit cardholders from purchasing certain supplies or services by blocking specific MCCs.

unauthorized purchases. For instance, if a cardholder used his or her government purchase card to obtain a cash advance, which is prohibited by Education's policies, the MCC for this type of transaction would appear on the report next to the cardholder's name. Further, Bank of America can block specific MCCs to prohibit certain types of charges that are clearly not business related such as purchases from amusement parks and movie theaters. However, Education officials told us that they do not use this control because the Department relies on Approving Official's review of the cardholder's purchases.

The fact that Education does not review MCCs as a check on cardholder transactions or block certain MCCs, is particularly significant given the inconsistent supervisory review and the inherent risk of fraud and abuse associated with of credit card purchases. Together, they mean that Education is not using preventive measures at its disposal – through the review of MCC codes or the blocking of certain purchases – or detective measures – the review and approval of purchases. Thus, the risk of improper payments is substantially increased.

Fiscal Year 2000 Financial Statement Audit

Education's fiscal year 2000 audited financial statements were issued on January 26, 2001, before the March 1, 2001, deadline, and Ernst & Young's opinion on the financial statements improved over that of fiscal year 1999. Ernst & Young issued a qualified opinion[7] on all five of the fiscal year 2000 required financial statements. For fiscal year 1999, Ernst & Young issued qualified opinions on four of Education's financial statements and a disclaimer[8] on the Statement of Financing. Ernst & Young also reported that Education continued to have serious internal control and financial management systems weaknesses. Ernst & Young reported the following reasons for the qualification of its audit opinion:

- During fiscal year 2000, significant financial management weaknesses continued to impair Education's ability to accumulate, analyze, and present reliable financial information. Extensive manual adjustments enabled Education to partially compensate for, but did not correct, certain aspects of the material weaknesses in its financial reporting process.

- Education was unable to provide adequate documentation to support certain amounts reported in net position included in the consolidated

[7]Such an opinion is expressed when (1) there is a lack of sufficient competent evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he or she cannot express an unqualified opinion and he or she has concluded not to disclaim an opinion or (2) the auditor believes, on the basis of his or her audit, that the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, and he or she has concluded not to express an adverse opinion.

[8]A disclaimer of opinion is expressed when the auditor is unable to obtain satisfaction that the financial statement is fairly presented and does not express an opinion.

balance sheet, and Ernst & Young was unable to perform other audit procedures to satisfy themselves that the net position amount was correct.

- Education inconsistently processed certain transactions related to prior years as fiscal year 2000 activity and was unable to provide Ernst & Young with adequate documentation that these manual transactions were properly reflected in the appropriate period.

In addition, Ernst & Young's report on internal controls for fiscal year 2000 included three material internal control weaknesses[9]—all long-standing from prior years. For the purposes of financial statement preparation, internal controls are to provide reasonable assurance that the financial results reported are reliable, the agency is in compliance with laws and regulations, and performance reporting is reliable. When the design of internal controls is weak, errors, fraud, or noncompliance with laws and regulations may occur that elevate the weakness to a material internal control weakness.

The specific material internal control weaknesses cited by Ernst & Young for fiscal year 2000 were (1) weaknesses in the financial reporting process, (2) inadequate reconciliations of financial accounting records, and

[9]A material internal control weakness is used to describe a condition where an agency's internal controls do not reduce to a relatively low level the risk that errors, fraud, or noncompliance involving significant amounts may occur and may not be detected within a timely period by employees in the normal course of performing their assigned functions.

(3) inadequate controls over information systems. Specifically, Ernst & Young reported that:

- Education did not have adequate internal controls over its financial reporting process. Its general ledger system was not able to directly produce consolidated financial statements as would normally be expected from such systems. Because of this weakness, Education once again had to resort to a costly, labor-intensive, and time- consuming process involving manual and automated procedures to prepare financial statements for fiscal year 2000 as it had in previous years.

- Again, similar to previous years, Education did not properly or promptly reconcile its financial accounting records throughout fiscal year 2000 and could not provide sufficient documentation to support some of its financial transactions, specifically entries to correct prior year errors. In some instances, Education adjusted its general ledger to reflect the balance in its subsidiary records, without sufficiently researching the cause for differences.

- Furthermore, Education was not able to identify and resolve differences between its accounting records and cash transactions reported by the Treasury for the past several years. Reconciling agencies' accounting records with relevant Treasury records is required by Treasury policy and is analogous to individuals reconciling their checkbooks to monthly bank statements. Because most assets, liabilities, revenues, and expenses stem from or result in cash transactions, errors in the receipt or payment data affect the accuracy of the individual agency financial reports and various U.S. government financial reports, including data provided by agencies for inclusion in the President's Budget concerning fiscal year outlays. Further, the lack of effective reconciliations increases the risk of fraud, waste, abuse, and mismanagement of government funds.

- Ernst & Young's report discussed the seriousness of Education's computer systems weaknesses. Ernst & Young found that Education had not completed its corrective action plan to ensure that all mission critical systems had adequate security plans and that corrective actions were taken to mitigate known exposures. Additionally, Education had information systems control deficiencies in (1) monitoring and reviewing access to sensitive computer resources, (2) implementing a system software change management process, and (3) developing and testing a comprehensive disaster recovery plan to ensure the continuity of critical system operations in the event of disaster.

As a result, it took a lot of hard work by Education staff and costs for contractor assistance to develop the information needed for financial statements that were issued 4 months after the end of the fiscal year; information that should be but is not routinely available. Education needs to be able to generate reliable, useful, and timely information on an ongoing basis to ensure adequate accountability to taxpayers, manage for results, and help program and congressional decisionmakers make timely, well-informed judgements for day-to-day management and oversight. This is what the Congress was seeking when it enacted the Chief Financial Officers Act of 1990 and other financial reform legislation. While an unqualified audit opinion is an important milestone, it is not the end goal.

Obtaining an unqualified audit opinion must be combined with sustained efforts to improve underlying financial management systems and controls. As the Comptroller General testified on March 30, 2001,[10] if agencies (such as Education) continue year after year to rely on significant, costly and time-intensive manual efforts to achieve or maintain unqualified opinions without such improvements, it can serve to mislead the Congress and the public as to the true status of agencies' financial management capabilities. In such a case, an unqualified opinion would become an accomplishment without much substance. As we look ahead, it will be essential for Education to strengthen its financial reporting to make more meaningful information available to the Congress, other policymakers, and the American public.

[10] *U.S. Government Financial Statements: FY 2000 Reporting Underscores the Need to Accelerate Federal Financial Management Reform* (GAO-01-570T, March 30, 2001).

To summarize, internal control and financial management weaknesses at Education are not new. Last year we testified three times about the financial management challenges faced by Education and the need to eliminate internal control weaknesses to reduce the potential for fraud, waste, and abuse at the Department[11] and Ernst & Young and the IG have reported serious internal control problems. Our ongoing work is showing that Education in several cases is not taking advantage of available means to use or improve its controls over the review, approval, issuance and recording of payments. In addition, the most recent financial statement audit disclosed continuing serious weaknesses over (1) the financial reporting process, (2) inadequate reconciliations of financial accounting records, and (3) inadequate controls over information systems. Until Education is able to correct its serious internal control and system deficiencies, it will be hindered in its ability to achieve lasting financial management improvements. As a result, it will continue to face an increased risk of improper payments.

In the next phase of our work, we will be employing various computerized techniques, referred to as “forensic auditing” techniques, to identify data anomalies that may be indicative of improper payments. These techniques include data base searches, file comparisons and computer matches, and other analyses to identify unusual transactions and unusual payment patterns. Using this approach we can identify questionable payments – for example payments to closed schools or to individuals with invalid social security numbers. We will research and, as needed, investigate any questionable payments to determine whether they represent simple data errors or are in fact improper payments or even fraud. We will be in a position to report to you on the results of this work sometime this summer.

In closing, Mr. Chairman, I want to underscore the importance of Education's top management giving priority to (1) addressing the problems preventing the auditors from being able to express an unqualified opinion on Education's financial statements, (2) having effective internal control, and (3) modernizing financial management systems.

Finally, I want to reiterate the value of sustained Congressional interest in these issues, as demonstrated by this hearing and those you have held in the past to oversee financial management reform at Education. Your work

[11] *Financial Management: Education Faces Challenges in Achieving Financial Management Reform* (GAO/T-AIMD-00-106, March 1, 2000), *Financial Management: Education's Financial Management Problems Persist* (GAO/T-AIMD-00-180, May 24, 2000), and *Financial Management: Financial Management Challenges Remain at the Department of Education* (GAO/T-00-AIMD-00-323, September 19, 2000).

and that of the Committee over the past years to facilitate management improvements at Education have been a catalyst to the progress we have seen to date and will be critical to ultimately solving the Department's serious long-standing internal control and financial management systems weaknesses.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other Members of the Subcommittee may have.

Contact and Acknowledgment

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