DEPARTMENT OF HEALTH AND HUMAN SERVICES,
ADMINISTRATION FOR CHILDREN AND FAMILIES
Washington, D.C.

INDEPENDENT AUDITOR'S REPORTS
September 30, 2001 and 2000

DEPARTMENT OF HEALTH AND HUMAN SERVICES,
ADMINISTRATION FOR CHILDREN AND FAMILIES

INDEPENDENT AUDITOR'S REPORTS
September 30, 2001 and 2000

TABLE OF CONTENTS

PAGE

Independent Auditor's Report

To the Inspector General of the
Department of Health and Human Services and
the Administration for Children and Families

We have audited the accompanying consolidated balance sheets of the Administration for Children and Families (ACF), an operating division of the Department of Health and Human Services (HHS), as of September 30, 2001 and 2000, and the related consolidated statements of net cost and changes in net position, combined statements of budgetary resources, and consolidated statements of financing for the years then ended (collectively the Financial Statements). These financial statements are the responsibility of ACF's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to the 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.* Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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.

In our opinion, the Financial Statements present fairly, in all material respects, the financial position of ACF at September 30, 2001 and 2000, and its net cost; changes in net position; budgetary resources; and reconciliation of net cost to budgetary obligations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our reports dated December 28, 2001 on our consideration of ACF's internal control over financial reporting, and on our tests of ACF's compliance with certain provisions of laws and regulations. Those reports are an integral part of our audits performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Our audits were made for the purpose of forming an opinion on the basic Financial Statements taken as a whole. The Management Discussion and Analysis and the other Required Supplemental Information is not a required part of the Financial Statements but are supplementary information required by OMB Bulletins entitled *Form and Content of Agency Financial Statements* (No. 97-01, as amended, and the portions of No. 01-09 that are required to be implemented in fiscal 2001). The Other Accompanying Information is presented for the purposes of additional analysis and is not a required part of the Financial Statements. Such information contains a wide range of data, some of which are not directly related to the Financial Statements. We have applied certain limited procedures, which consisted principally of comparing this information for consistency with the Financial Statements and discussing the methods of measurement and presentation with ACF management. However, we did not audit the information and express no opinion on it.

Clifton Gunderson LLP

Calverton, Maryland
December 28, 2001

Independent Auditor's Report on Compliance with Laws and Regulations

To the Inspector General of the
Department of Health and Human Services and
the Administration for Children and Families

We have audited the Financial Statements of the Administration for Children and Families (ACF), an operating division of the Department of Health and Human Services (HHS), as of and for the year ended September 30, 2001 and have issued our report thereon dated December 28, 2001. We conducted our audit 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.*

The management of ACF is responsible for complying with laws and regulations applicable to ACF. As part of obtaining reasonable assurance about whether ACF'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 affect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to ACF.

The results of our tests of compliance with laws and regulations described in the preceding paragraph, exclusive of FFMIA, disclosed an instance of noncompliance with the following law and regulation that is required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, which is described below.

- The Federal Managers Financial Integrity Act of 1982 (FMFIA), and the related Office of Management and Budget(OMB) Circular A-123 issued under the Act, requires agencies to issue an Annual Statement to OMB on whether the agency's financial management systems and automated information security programs conform with government-wide requirements, as defined by OMB Circular A-127. OMB Circular No. A-130, Appendix III, requires agencies to report security deficiencies and material weaknesses within their FMFIA reporting mechanisms as defined by OMB Circular No. A-123, and take corrective actions in accordance with that directive. ACF's Annual Statement for fiscal 2001, dated December 17, 2001, did not include appropriate reference to its financial management and automated information security programs. In addition, weaknesses noted in a report issued by the Office of the Inspector General on September 7, 2001, relating to the provisions of the Government Information Security Reform Act of 2000, were not considered in the aforementioned Annual Statement.

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

Under FFMIA, we are required to report whether ACF's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed no instances in which ACF's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of ACF, HHS, the HHS Office of the Inspector General, OMB and Congress, and is not intended to be, and should not be, used by anyone other than these specified parties.

Clifton Gunderson LLP

Calverton, Maryland
December 28, 2001

Independent Auditor's Report on Internal Control

To the Inspector General of the
Department of Health and Human Services and
the Administration for Children and Families

We have audited the Financial Statements of the Administration for Children and Families (ACF), an operating division of the Department of Health and Human Services, as of and for the year ended September 30, 2001, and have issued our report thereon dated December 28, 2001. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to the 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.*

In planning and performing our audit, we considered ACF's internal control over financial reporting by obtaining an understanding of ACF'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 (31 U.S.C. 3512), 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 ACF'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 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 section involving the internal control and its operation that we consider to be reportable conditions. However, none of the reportable conditions is believed to be a material weakness.

In addition, we considered ACF's internal control over Required Supplementary Stewardship Information by obtaining an understanding of ACF's internal control, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 01-02, and not to provide assurance on these internal controls. Accordingly, we do not provide assurance on such controls.

Finally, with respect to internal controls related to performance measures reported in ACF's Management's Discussion and Analysis, 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.

****

We have noted improvement in ACF's internal control system since last year, and some of the matters noted in our prior report have been resolved. However, certain matters raised in our prior year report continue to need improvement. We have described the reportable conditions below.

HHS's Assistant Secretary for Budget, Technology, and Finance (ASBTF) office provides the Department-wide accounting policy oversight to ACF. The Division of Financial Operations (DFO) of the Program Support Center (PSC) provides the accounting and fiscal services to ACF, including the preparation of annual financial statements. The Division of Payment Management (DPM) of the Program Support Center (PSC) provides grant accounting services to ACF, including grant disbursement, expenditure, and advance processing functions. Accordingly, DFO and DPM are considered part of the ACF's management and is responsible for carrying out many of the accounting procedures on behalf of ACF.

REPORTABLE CONDITIONS

1. GRANT ACCOUNTING

Condition: In our prior internal control audit report, we noted DPM's difficulty in generating reliable reports subsequent to its system conversion in July 2000. We previously recommended that resolution of material weaknesses in DPM's internal controls be closely monitored and user controls and other financial analysis procedures be expanded at ACF to compensate for the issues noted at DPM and to improve ACF's ability to thoroughly analyze information generated by its accounting system. During our review of ACF's grant accounting systems and procedures, including tests of a sample of several grant transactions during the year, we continue to note the following weaknesses in ACF's grant accounting systems, which collectively are considered a Reportable Condition, as defined:

a) ***Grant Accrual*** - ACF uses the simple linear regression model (RM), based on historical expenditures, to calculate its accrual estimate of grant expenditures not reported by grantees as of the end of the year. In order to place more reliance on the RM for the year ended September 30, 2001, ACF attempted to test the RM grant accrual estimate quarterly during fiscal 2001. However, this pro-forma test resulted in calculated amounts significantly different than actual SF 272 expenditure reports submitted by grantees after the end of the relevant quarter. Differences ranged from an under accrual of $644 million in the first quarter to an over accrual of $667 million in the third quarter.

ACF management believed that the aberrations experienced during the first three quarters of fiscal 2001 resulted from prior year reporting problems at DPM carrying over into fiscal 2001; however, definitive support for this belief was not readily available. The fourth quarter RM generated accrual estimate was more in line with the actual SF 272 expenditure reports; however, the RM must be further tested during fiscal 2002 in order to place full reliance on the RM at September 30, 2002 and beyond.

b) ***Grant Financial Analysis*** - The first draft of ACF's Statement of Net Cost for the year ended September 30, 2001 reflected significant fluctuations in certain programs over that reported in fiscal 2000. For example, Refugee Resettlement costs decreased by thirty-six percent ($160 million), yet total appropriations increased ($21 million). In addition, Head Start expenses increased by twenty-nine percent ($1.3 billion) and Low-Income Home Energy Assistance costs were not in line with amounts reported on Treasury's Annual Report by $513 million. Management could not initially provide explanations for the fluctuations, which appears to indicate the need for more complete analysis of the results reflected in ACF's accrual based financial statements. During the audit process, $ 500 million of adjustments were made to GRPA cost amounts reflected on the initial draft of the Statement of Net Cost. Similar financial analysis difficulties were noted at June 30, 2001 when ACF attempted to analyze its interim financial results.

Even though certain reconciliation and account activity analysis procedures performed by ACF are good, they do not necessarily reveal the unusual relationships among the grant accounts. Also, analysis procedures at the GPRA level should be part of the normal reconciliation process. Therefore, the study of fluctuations of the grant balances from year to year (and quarter to quarter) is essential in spotting other errors not identified through ACF's routine reconciliation processes. ACF ultimately concluded that the fluctuation of GPRA program costs reported on their financial statements in fiscal 2001 and fiscal 2000 were reasonable only after exhaustive research and analysis of those program activities in those fiscal years.

c) ***<u>Grant Transaction Processing, Monitoring and Reconciliation</u>*** - The following matters were noted during our tests of transactions during the year:

- A grantee, which was over-advanced by $73 million several years ago, remains in ACF's subsidiary ledger as of September 30, 2001. This error resulted in the grantee drawing more funds than that initially authorized and ACF has yet to adjust the grantee's future draws to "pay back" this over-advanced situation or make attempts to collect such prior year overdraws. Management has informed us that this situation occurred as a result of a disallowance. ACF has not taken timely action to fully correct the situation and, accordingly, the matter is unresolved with the grantee at September 30, 2001. In fiscal 2001, ACF tried to correct this problem in its accounting system but inappropriately adjusted its subsidiary ledger by creating documents with zero obligations.

- An adjustment ($18 million) was made to a grant expenditure amount reflected in PMS and in the general ledger system (CORE) without initially being adequately supported by an SF-272.

- For one grantee, ACF processed a penalty assessment of $58 million through a de-obligation after the grantee had drawn down funds and reported expenditures to DPM. The expenditures exceeded authorization amounts reflected in CORE and PMS by $29 million. This situation indicated a lack of proper review procedure by ACF to ensure that the account was reconciled with DPM before such a major de-obligation was processed. In a separate instance related to the same grantee, the de-obligation of certain grants ($41 million) existed in holding files for several months without being recorded in PMS and such transactions were not resolved by the end of the year, resulting in negative obligations in CORE at September 30, 2001.

- Certain grant transactions (with an absolute value of $16 billion) were misclassified between intra and non-governmental accounts in the general ledger. Correction of these errors were not posted to the general ledger, but instead were used to support a manual adjustment to ACF's financial statements.

Recommendation: We recommend the following:

a) Continue to test the reasonableness of the Regression Model (RM) accrual methodology. This test should include comparing RM accrual estimates with actual SF 272 expenditure reports submitted by grantees after the end of the relevant quarter. Analytical procedures should be developed to assess the results of this test in light of management's expectations and knowledge about their grant programs, in partnership with DPM. Historical trend analysis can also assist management in demonstrating the reasonableness and reliability of the accrual developed by the RM.

   The importance of this testing and analysis is further magnified by the fact that OMB plans to accelerate further the due dates of the Agency Financial Statements in future fiscal years. Under these compressed schedules, actual expenditure data will not be available during the audit process to support and/or adjust many of the accruals in the financial statements, including the grant accrual. Therefore, increased management attention and analysis must be focused on periodic analytical reviews of the reported grant financial data throughout the year.

b) Obtain a Statement of Net Cost from DFO on a quarterly basis, compare amounts reflected on the Statement to those reflected in prior periods, and determine reasonableness of current period amounts given management's expectations of operating results. The study of fluctuations from year to year can facilitate an understanding of why the balances are as reported. ASBTF has issued a policy memorandum in November, 2001 outlining various analytical review procedures for use in the grants area. We recommend that ACF implement the provisions of this memorandum, as appropriate, immediately.

c) The following recommendations should be considered by management to improve the accuracy and efficiency of grants transaction processing:

- ACF should continue to perform monthly reconciliations at the document level for obligation, expenditure and advance data. Differences between ACF and the amounts reported by DPM should be researched more thoroughly and resolved more timely. Appropriate communications should be made with DPM to adjust their data and/or reports, if necessary. The general ledger should also be adjusted for the errors identified during this reconciliation process in a timely manner. Unusual transactions, especially over-advance situations, needing corrective action identified during the reconciliation process should also be resolved with the grantee immediately, thus ensuring management's efficient and effective management of government assets as stated in Statement of Federal Financial Accounting Standards Number 1. In addition, consideration should be given to writing off old over-advances deemed uncollectible, if warranted.

- A separate examination was performed on data processing controls at DPM (SAS 70) in fiscal 2001 indicated that grant recipients are responsible for reporting the expenditure of Federal grant funds on a quarterly basis to DPM. The DPM Liaison Branch Accountant is responsible for ensuring that the expenditure data, reported by the grant recipient, is properly entered into PMS. We recommend that grantee reported SF 272s be the source for the expenditure information reported in the financial statements. If a grantee has reported incorrect expenditure data, prompt follow-up action on inaccurate reports should be taken by DPM.

  The audit referred to above, also indicated that it was ACF's ultimate responsibility to correct and resolve authorization holding file transactions in a timely manner and to resolve award authorization and expenditure discrepancies with its grantee. ACF should perform thorough reconciliations of its grants' transactions during the year and be the ultimate authority to initiate the correction of any errors identified during this process. This process should include CORE edit checks and periodic manual reviews to prevent over deobligations and over advances/expenditures from occurring at the document level. These type transactions should be routed to a suspense/holding file until corrective action is taken. Transactions should also be reviewed for proper governmental classification.

- Develop procedures to properly classify transactions as governmental or non-governmental when they are initially recorded in the accounting system.

2. PREPARATION AND ANALYSIS OF FINANCIAL STATEMENTS

Condition: Pursuant to OMB directives, beginning in fiscal 2002, an Agency must obtain an audit of its September 30th financial statements by February 1st of the following fiscal year, and further acceleration of this time frame is expected in the future. In addition, interim financial statements at March 31st (unaudited) will be required beginning in fiscal 2002, and then quarterly in fiscal 2003. Such interim statements must be submitted to OMB within 60 and 45 days, respectively, of the period end.

Even though ACF continued to make improvements in its accounting systems and procedures in fiscal 2001, we believe that ACF's financial preparation and analysis procedures continue to need refinement, especially in order to comply with these new reporting requirements in fiscal 2002 and beyond. This refinement should allow ACF to prepare more reliable financial statements in a more timely and efficient manner at year end and during the year as well. It should also assist ACF in complying with the more stringent reporting requirements in the future referred to above.

The following matters serve to support this conclusion:

- **<u>Review and Analysis of Budgetary and Net Position Accounts Needs Improvement</u>**
  ACF continued to have difficulty in preparing accurate Budgetary Resources and Financing statements in fiscal 2001. The statements prepared at September 30, 2001 contained several material errors identified during the audit, including one for approximately $ 2 billion that changed several line items on the statements.

  ACF also continued to record a significant number of miscellaneous adjustments in various net position accounts during the year that made the reconciliation of these accounts to amounts reflected in the Budgetary Statement difficult and time consuming to perform at September 30th. These miscellaneous adjustments (approximately $10 billion) record both the impact of prior year adjusting journal entries and adjustments needed to reconcile other accounts at year-end. It appears that the adjustments are at times posted to the Access database without fully investigating the impact to the net position accounts. Even though no material audit adjustments were made to the total of all Net Position accounts at September 30, 2001, the composition of the Unexpended Appropriations reflected in the notes to the financial statements were revised by the $2 billion amount referred to above.

ACF continues to fail to complete periodic reconciliations of Appropriated Capital Used and Expended Authority accounts, as required by HHS Departmental policy. These reconciliations could provide valuable insight into ACF's determination of the reasonableness of amounts reflected on the Budgetary and Net Position statements.

- **<u>Financial Statement Preparation Process and Analysis Can Be Improved</u>** – ACF's process for preparing the annual financial statements in the Core Accounting System (CORE) continues to be manually intensive and provides for limited resources being available for financial analysis and related research of unusual account relationships. It includes downloading necessary data from CORE, and using microcomputer software to process adjusting entries and to prepare annual financial statements. Even though ACF has improved the timeliness of this process in fiscal 2001, this process is time consuming, has a high risk for error and does not include procedures to ensure the completeness of the final data used to prepare the financial statements. Accordingly, the need for additional financial analysis is critical to reduce the likelihood of errors from these risks.

  Once the financial statements were prepared for September 30, 2001, ACF did not prepare a complete analysis of the results reflected in its accrual based financial statements especially with respect to the GPRA balances reflected in the Statement of Net Cost. When ACF prepared interim statements at June 30, 2001, they were unable to provide any explanations of fluctuations with balances at June 30, 2000, or fluctuations with balances at September 30, 2000. In comparing the reported balances at September 30, 2001 and 2000, ACF was unable to provide us with a complete explanation of unusual fluctuations until two months after its financial statements were provided to us for audit. Examples of these difficulties are described in the Grant reportable condition comment beginning on page 6. The research of these fluctuations resulted in the realization that amounts originally reported were in error, and adjustments were needed to the initial amounts reflected in the statements initially provided to us. These errors also impacted the amounts reflected in the Consolidating Statements, reported as supplemental information to the basic financial statements.

  Recommendation: The financial analysis and reconciliation procedures in place during fiscal 2001 were not completely effective in the production of reliable financial statements and in identifying errors prior to audit. Interim financial statements, required beginning in fiscal 2002, will not be audited therefore the accuracy of such financial statements must be improved. In order to better prepare for the implementation of OMB Bulletin # 01-09, we recommend that refinements be continued on the following areas:

  a) Reevaluate the manual aspects of the financial statement preparation process currently in use and develop enhancements to streamline the process. The new interim reporting requirement for fiscal 2002 may be a good vehicle to test these new processes.

  b) Begin planning for the preparation of the interim financial statements for March 2002 immediately to fine tune preparation and analysis procedures to comply with the new OMB requirements. These interim financial statements will require the recording of all transactions in the general ledger, including accrual entries, and preparing a complete set of financial statements similar to those prepared at the end of the year. This will allow ACF to analyze all major accounts, including net position and budgetary accounts, and comparing account relationships with amounts reflected in the prior year audited financial statements and the prior year interim financial statement, if available. ACF management should investigate unusual changes from year to year and obtain explanations from appropriate program managers for significant deviations. In addition, consideration should be given to performing comparisons with expected expenditure amounts.

After analyzing the results of the interim review process, ACF could then adjust its accounting procedures before the year-end financial statement preparation process to correct the cause of errors identified in such interim financial statements. This could reduce the time needed to close the accounting records and prepare the financial statements at September 30th.

c) Evaluate accounting entries not currently posted in CORE and consider posting such entries in the general ledger, including those related to entries processed in the normal course of operations in the subsequent fiscal year that should be reversed.

d) Analyze and reconcile the net position general ledger accounts throughout the year to minimize this effort at year-end. We also continue to recommend that all audit and year-end closing adjustments be recorded in the CORE Accounting System to avoid reconciliation problems in net position accounts in future years.

e) Establish a function in ACF to perform critical analysis of financial statements generated by its staff to ensure objectivity and accuracy of reported amounts.

3. ELECTRONIC DATA PROCESSING CONTROLS

Condition: Our tests of internal controls placed in operation over the preparation of ACF's Financial Statements at September 30, 2001, include a review of controls placed in operation over significant accounting systems supporting ACF's basic accounting system (CORE). These supporting systems, such as the as Grants Administration Tracking and Evaluation System (GATES), are often referred to as "feeder" systems.

OMB Circular A-130, Appendix III, "Security of Federal Automated Information Resources," established a minimum set of controls for federal agencies. Such controls include contingency planning, risk assessments, assigning responsibility for security, security planning, periodic review of security controls, and management authorization of systems to process information.

During our review of ACF's security of its information resources, we noted the following weaknesses, which collectively are considered a Reportable Condition, as defined:

a) **Government Information Security Reform Act (GISRA)** – GISRA requires, among other things, annual agency program reviews and annual independent evaluations for both unclassified and national security programs. The Act seeks to ensure proper management and security for the information resources supporting Federal operations and assets. The Office of the Inspector General issued its report on ACF's compliance with GISRA on September 7, 2001. The report identified several security weaknesses at ACF. ACF management has developed an action plan to address the issues noted in the report. We have provided ACF management with a separate letter outlining areas of particular security concerns noted during our audit.

b) **Data Processing Service Continuity Controls** - ACF's ability to respond to a disruption in business operations as a result of a disaster or other long-term emergency is incomplete.

Recommendation:

a) Implement appropriate actions to resolve the weaknesses identified in the aforementioned OIG GISRA report.

b) Complete development and implementation of plan to improve continuity controls, including formal measures to address a disruption of business operations.

4. ELECTRONIC DATA PROCESSING AT ACF'S SERVICE PROVIDER

Condition: Other auditors reviewed the Electronic Data Processing (EDP) controls at ACF's service providers. Their report furnished to us identified several weaknesses in internal EDP controls that collectively are considered a Reportable Condition. The weaknesses are explained in more detail in a separate Independent Service Auditor's Report dated October 15, 2001 entitled "SAS 70 Report on Controls Placed in Operation and Tests of Operating Effectiveness for the Division of Financial Operations" for the period October 1, 2000 to September 30, 2001." The condition categories in the current SAS 70 report are mostly the same as those noted in prior year reports, and are summarized as follows:

- Entity-wide security program planning and management
- Access controls
- Segregation of duties
- Application software development and change control

Recommendation: We continue to recommend that DFO develop and/or revise existing procedures to compensate for the weaknesses noted in the aforementioned report.

****

Attached to this report are Management's Responses to the findings and recommendations summarized above. We have reviewed Management's Responses, considered their points and reevaluated our finding or recommendation. We have concluded that no change is needed to our original finding or recommendation. We will work closely with management to help them fully understand the key points of our recommendations.

In addition to the reportable conditions described above, we noted certain matters involving internal control and its operations that we reported to the management of ACF in a separate letter dated December 28, 2001.

This report is intended solely for the information and use of the management of ACF, HHS, the HHS Office of the Inspector General, OMB and Congress, and is not intended to be, and should not be, used by anyone other than these specified parties.

Clifton Gunderson LLP

Calverton, Maryland
December 28, 2001

APPENDIX
MANAGEMENT RESPONSE TO AUDITOR INTERNAL CONTROL REPORT
December 28, 2001

APPENDIX
DEPARTMENT OF HEALTH AND HUMAN SERVICES,
ADMINISTRATION FOR CHILDREN AND FAMILIES
MANAGEMENT RESPONSE TO AUDITOR
INTERNAL CONTROL REPORT
December 28, 2001

The following represents Management's Response to the Conditions and Recommendations included in the Independent Auditor's Report on Internal Control dated December 28, 2001, beginning on page 6 of this document. The specific Condition and Recommendation should be read in connection with the following Management Responses.

LAWS AND REGULATION COMPLIANCE

1) FMFIA NON-COMPLIANCE

Management Response: It has been ACF's practice to provide an overall assurance in the annual FMFIA report stating the adequacy of management controls throughout the agency and noting material weaknesses as necessary. However, in accordance with OMB Circular A-123, in future FMFIA reports we will include a separate assurance stating whether our financial management systems and automated information security programs are in conformance with OMB Circulars A-127 and A-130, and report security deficiencies and material weaknesses as necessary.

INTERNAL CONTROLS

1) GRANT ACCOUNTING

Management Response: Specific comments for each segment of the recommendations are as follows:

a) <u>Grant Accrual</u> - ACF has reviewed the regression model (RM) on a quarterly basis for fiscal year 2001. However, as a result of the PSC-272 problem with the implementation of the new PMS, the fluctuation in the December, March, and June Regression Analysis (RA) created a situation where the analysis to determine the appropriateness of the RA was severely hampered. We believe that beginning with September 2001and forward, the data will be sufficient to analyze the RM and opine on its validity. We believe substantial improvements were made to the regression model during the fiscal year. We will continue to identify and investigate other improvements, and will continue to monitor the regression estimate differences to help identify future changes that are necessary.

b) Grant Financial Analysis - Quarterly financial statements will be required and prepared as of March 2002 and thereafter. ACF and PSC will work together to add additional resources to timely analyze quarterly net cost statements that contain over 96% grants expenditures.

c) Grant Transaction Processing, Monitoring and Reconciliation - ACF believes that reconciliation errors are timely identified and corrected. The auditor's findings relate to two individual grantees, not the overall grant population.

- The case of the $73 million over-advance was created when ACF switched from a letter-of-credit system to the more advanced DPM grant accounting system. The situation was referred to the Office of General Counsel (OGC), but multiple litigation claims and attempts at collection have been unsuccessful as of the time of this audit. ACF will continue to work with OGC and the PSC to determine likelihood of collection to resolve this situation.

- It is the normal process for the DPM to use the SF 272s as the source for expenditures posted in the PMS. However, in the case of the item noted the grantee is a very large state grantee with several hundred grant documents totaling billions of dollars. This recipient reports disbursements in a slightly different manner from standard procedures requiring manual review and entry by the DPM staff. The DPM staff notifies the grantee in writing of any adjustments to the disbursements required prior to posting into the PMS. Additionally, certification or confirmation from the grantee is required.

- The stated finding is related to a unique situation in which a State grantee was changed in the middle of a fiscal year. The penalty assessment that created this situation was a valid de-obligation. Later reconciliations, however, revealed that the de-obligation was improperly keyed. The correction was identified prior to the conclusion of the audit.

  Additionally, ACF believes that the $29 million excess of expenditures over authorizations was not calculated on the grant document taken as a whole, but was calculated on an individual funding year within the grant document. The grantee (i.e., the grant document) had not exceeded its total authorizations.

  Finally, the program in question requires that adjustments between grantee estimates and actual expenditures be made on a quarterly basis. The $41 million de-obligation was a valid quarterly adjustment within the grant document. The new DPM accounting system does not allow a FY within a grant document to become negative. Thus, the transaction was sent to a holding file. Because the program policy allows for a negative balance to exist, the ACF and DPM were in agreement as to the resolution. ACF grant officers for this program will work with the DPM to resolve this situation.

- Procedures currently exist to properly classify transactions as governmental or non-governmental when they are initially recorded in the accounting system. Further, there is a compensating control within the financial statement preparation process that will reveal any misclassification(s) prior to issuance of the financial statements. The financial statements were not in danger of being misstated. A system correction is still necessary, however. The cause of this misclassification issue was identified and will require significant resources to re-code a large volume of transactions. The correction should be completed within FY 2002.

2) PREPARATION AND ANALYSIS OF FINANCIAL STATEMENTS

Management Response: We concur with the finding in general and provide specific comments for each segment of the recommendation below.

a) DFO will continue to develop enhancements to streamline the manual preparation of the financial statements. However, we are of the opinion that the current process (ACCESS) used is the best available software/data base to convert general ledger data into financial statement line items and, at the same time, maintain an audit trail for financial statement adjustments.

b) With the preparation of interim financial statements beginning with March 2002, DFO will provide ACF with a complete set of financial statements. ACF management will be provided with data necessary to analyze and adjust its accounting procedures prior to the year-end statements.

c) We concur that DFO should consider posting most accounting entries to the CORE Accounting System. DFO will review each account entry (JV) and will make the determination if it should be posted in CORE.

d) With the preparation of interim financial statements beginning with March 2002, DFO and ACF will analyze and reconcile the net position general ledger accounts. Accounting adjustment (JV's) will be reviewed by DFO to determine if they should be posted in CORE.

e) ACF and PSC will work together to add additional resources to analyze quarterly statements.

A Department-wide task force, containing ACF representatives, is in the process of developing a financial accounting system – the Unified Financial Management System (UFMS). The UFMS will, among many other requirements, produce automated, real-time financial statements. The UFMS is scheduled to be in operation in FY 2004.

ACF does have the necessary knowledge to analyze the Statement of Net Cost. The delays in providing the analytical review workpapers are inherent in the manual financial statement process. ACF relies on the PSC staff to lend its accounting expertise to the analytical review process. The UFMS will be designed to improve the analytical review process. ACF agrees that the current analytical review process can be improved and will work with the PSC and the department to refine the process.

3) ELECTRONIC DATA PROCESSING CONTROLS

Management Response: ACF has reviewed the subject Independent Audit Report, specifically those comments concerning the Office of Inspector General (OIG) GISRA review findings and other IT security issues. We believe that the OIG Audit Report overemphasizes certain IT security issues and does not give credit for ACF's IT security initiatives and progress. In addition, each of the IT security issues the Audit Report highlights is actively being worked on at this time and should be remedied before the next Independent Audit Review is undertaken.

4) ELECTRONIC DATA PROCESSING AT ACF'S SERVICE PROVIDER

Management Response: The condition categories referred to in the finding are the same as those in the prior SAS 70 reviews, but some of the details of the categories are different (Segregation of Duties) and there is one additional (Entity-wide security program planning and management). We are in the process of finalizing an Entity-wide Security Plan. Regarding the Segregation of Duties condition, we have separated the program change function from the production function. The government employee that moves programs to production also performs testing to assure that the program changes have been made correctly. However, it is important to note that this individual is not permitted to make program changes. The tests are performed to assure that program changes have been completed as specified. All change requests are initially approved by the Systems Branch Chief and copies of approved requests are provided to the individual who places them into production. To ensure that program changes are appropriate, we have added an additional sign-off requirement (Systems Branch Chief) in the procedure just before the change is placed in production for those programs that have been tested and moved by the same government employee. We do not believe that a corrective plan is necessary for the Segregation of Duties issue. We believe this process meets all security standards.