kpmg

2001 M Street, NW
Washington, DC 200353389

INDEPENDENT AUDITORS' REPORT

Director, U.S. Office of Personnel Management:

We have audited the accompanying balance sheet of the Life Insurance Program (LP), administered by the U.S. Office of Personnel Management (OPM) Retirement and Insurance Service (RIS), as of September 30, 1999, and the related statements of net cost, changes in net position, budgetary resources, and financing (hereinafter collectively referred to as "financial statements") for the year then ended. The objective of our audit was to express an opinion on the fair presentation of these financial statements. In connection with our audit, we also considered OPM's internal control over financial reporting related to the LP and tested OPM's compliance with certain provisions of applicable laws and regulations related to the LP that could have a direct and material effect on its financial statements.

In our opinion, based on our audit and the reports of other auditors, LP's financial statements as of and for the year ended September 30, 1999, are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

Regarding our consideration of internal control over financial reporting, we noted reportable conditions in the following areas:

1. EDP general control environment;
2. Budgetary accounting structure;
3. Reconciliation of inter-program transactions, and
4. Actuarial census data.

Regarding our tests of compliance with certain provisions of applicable laws and regulations, with the exception of the Federal Financial Managers' Integrity Act (FFMIA), we noted no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*, as amended.

Our conclusions and the scope of our work are discussed in more detail below.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying balance sheet of the LP as of September 30, 1999 and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended. We did not audit the financial statements of Metropolitan Life Insurance Company's Office of Federal Employees Group Life Insurance Program (OFEGLI), which statements comprise approximately 2% of total assets reflected in the LP balance sheet and substantially all current benefits reflected in the LP statement of net cost. Those financial statements were audited by other auditors, whose report thereon has been provided to us, and our opinion, insofar as it relates to the amounts included for OFEGLI, is based solely on the report of the other auditors.

In our opinion, based on our audit and the report of the other auditors, the financial statements present fairly, in all material respects, the financial position of the LP as of September 30, 1999, and its net cost, changes in net position, budgetary resources, and reconciliation of net cost to budgetary obligations for the year then ended, in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on LP's financial statements taken as a whole. The information included in the section entitled *Management Discussion and Analysis of the Retirement, Health Benefits, and Life Insurance Programs (MD&A)* and the required supplementary information in the schedule entitled *Life Insurance Program - Required Supplementary Information* is not a required part of the financial statements but is supplementary information required by Office of Management and Budget (OMB) Bulletin 97-01, *Form and Content of Agency Financial Statements,* as amended. Regarding the MD&A, we have considered whether this information is materially inconsistent with the financial statements. Regarding the required supplementary information, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information in the MD&A section of the LP or the required supplementary information and accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that:

- transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with generally accepted accounting principles;

- assets are safeguarded against loss from unauthorized acquisition, use, or disposition;

- transactions are executed in accordance with laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements and certain other laws, regulations and government-wide policies identified by OMB, as applicable to OPM, and

- transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit preparation of performance information in accordance with criteria stated by management.

Because of inherent limitations in internal controls, misstatements, losses, and noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of internal control over financial reporting to future periods is subject to the risk that the internal control procedures may become inadequate because of changes in conditions, or that the effectiveness of the design or operations of the policies and procedures may deteriorate.

We noted certain matters, described in items 1 through 4 below, involving the internal control over financial reporting and its operation that we consider to be reportable conditions under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 98-08, as amended. Reportable conditions are matters coming to our attention that represent significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the LP's ability to record, process, summarize, and report financial data consistent with the assertions of 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. However, we do not consider the reportable conditions described below to be material weaknesses.

The status of prior year findings is presented in Exhibit I. We also noted other matters involving internal control over financial reporting and its operation that we have reported to the management of OPM in a separate letter dated February 11, 2000.

1. EDP General Control Environment

(a) Entity-Wide Security Program

Certain areas in OPM's entity-wide security program could be strengthened. As noted in our prior year report:

- OPM does not have an integrated enterprise-wide security program, and has distributed security functions and responsibilities throughout the organization for data security, general support systems, application systems, and network operations. While different parts of the organization perform different functions, they share common hardware, software, and network platforms, and from a security perspective may be exposed to similar or interrelated vulnerabilities. The current distribution of security functions and responsibilities does not adequately ensure coordinated procedures, risk assessments, and monitoring and response capabilities. In contrast, the opportunity to leverage resources and realize opportunities may not be fully realized with the current decentralized security model.

- OPM has not performed a security risk assessment within the last three years. However, during that period OPM upgraded the mainframe and networking platforms and implemented a new core financial management system. While OPM plans to perform assessments, they have not been scheduled.
- OPM's draft *Information Technology Security Policy* addresses the need for a certification and accreditation process, but there is not one currently in place. OMB Circular A-130 requires "*that agencies consider risk when determining the need for and selecting computer-related control techniques. This risk assessment approach should include a consideration of the major factors in risk management: the value of the system or application, threats, vulnerabilities, and the effectiveness of current or proposed safeguards.*" Compliance with OMB Circular A-130 is a critical compliance indicator for the Federal Financial Management Integrity Act, and performance of periodic risk assessments is a critical component of achieving compliance with OMB Circular A-130.
- OPM does not have a formally established, integrated, and robust monitoring and response capability to ensure adequate network and systems security. A limited penetration study found vulnerabilities that were not properly mitigated. OPM immediately responded to these particular vulnerabilities, but does not have a mechanism to identify new risks or to verify that implemented changes were adequate or operating as intended.
- There is no official method of tracking employees that are terminated and/or separated from OPM to ensure that systems security and physical access privileges were appropriately revoked.

An entity-wide security program, including security policies and a related implementation plan, is the foundation of an entity's security control structure and a reflection of senior management's commitment to addressing security risks. Without a well-designed program, security controls may be inadequate; responsibilities may be unclear, misunderstood, or improperly implemented; and controls may be inconsistently applied. Such conditions may lead to insufficient protection of sensitive or critical resources and disproportionately high expenditures for controls over low-risk resources.

(b) Access Control

OPM's EDP access controls require modification. Access controls include physical controls and logical controls. Adequately controlling physical access to computer equipment is an example of a physical control. OPM's physical access control system for the mainframe did not record all security events. Logical controls include security software programs designed to prevent or detect unauthorized access to sensitive files. We noted certain user account groups with excessive privileges to mainframe resources, which could potentially undermine proper segregation of duties.

Access controls should provide reasonable assurance that computer resources (data files, application programs, and computer-related facilities and equipment) are protected against unauthorized modification, disclosure, loss, or impairment. The objectives of limiting access are to ensure that (1) users only have the access necessary to perform their duties; (2) access to very sensitive resources, such as security software programs, is limited to very few individuals; and (3) employees are restricted from performing incompatible functions or functions beyond their responsibilities.

(c) Application Change Control/Systems Development

Certain controls over the modification of application software programs are deficient. Establishing controls over the modification of application software programs helps to ensure only authorized programs and authorized modifications are implemented. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or "turned off" or that processing irregularities or malicious code could be introduced.

As noted in our prior year report, OPM has not developed a systems development methodology for application software, and the current "RSOD Retirement ADP Standards and Procedures" is missing critical chapters, including data set design and allocation, system development procedures, testing and acceptance, and system software installation and maintenance.

(d) Service Continuity

Losing the capability to process, retrieve, and protect information maintained electronically can significantly impact OPM's ability to accomplish its mission. For this reason, OPM should have procedures in place to protect information resources and minimize the risk of unplanned interruptions, as well as a plan to recover critical operations should interruptions occur. To mitigate service interruptions, it is essential that the related controls be understood and supported by management and staff throughout the organization. OPM has several separate ongoing service continuity-related initiatives and draft plans that need to be finalized, formalized, and properly coordinated so OPM can ensure that critical functions will still be available in the event of a disruption.

Recommendation

We recommend that OPM develop a formal action plan to review and revise its EDP general controls. This plan should address each of the four areas discussed above as well as other areas that impact the general EDP control environment. The plan should also set forth appropriate corrective action steps, assign responsibilities to employees, and establish target completion dates for each action. This plan should be reviewed by the Office of the Inspector General, adopted by executive management of OPM, and provide for periodic review of progress towards achievement of corrective actions.

2. Budgetary Accounting Structure

RIS continues to find it cumbersome to produce accurate and timely year end financial statements for the benefit plans. In fiscal year 1999, RIS implemented a new core financial management system for benefit plan accounting, but did not implement the budgetary accounting structure in its general ledgers. As a result, RIS manually calculated the budget figures in its statements of budgetary resources and financing, and several recalculations were necessary to produce accurate statements. In addition, RIS did not perform reconciliations between the budgetary amounts reported in the financial statements and the corresponding amounts reported on the SF-133 and SF-2108 forms. Without a set of self-balancing accounts to summarize budgetary activity, the risk of reporting inaccurate budgetary figures exists. The lack of a formal budgetary accounting structure resulted in our conclusion that the LP did not substantially conform with the requirements of FFMIA, in accordance with the guidelines contained in OMB Bulletin No 98-08, as amended.

Recommendation

We recommend RIS implement the budgetary accounting structure in the LP general ledger and begin recording budgetary accounting activity consistent with their policy statements. This action will assist RIS in preparing accurate year end financial statements.

3. Reconciliation of Inter-Program Transactions

Life insurance premiums are withheld from payments made to annuitants by the Retirement Program (RP). The RP is responsible for transferring these amounts to the LP. RIS records amounts for annuitant withholdings using data from an Annuity Roll Processing System (ARPS) report and records the offsetting payment using information from the Monthly Income Recap report. The reports originate from two different sources and do not reconcile. RIS has recognized this, but because of resource constraints, they have not taken appropriate action to reconcile these transactions.

Recommendation

As noted in our fiscal year 1997 and 1998 reports, we continue to recommend that RIS (1) request ADP services to gain extract data from the annuity roll system; (2) compare these transactions to the manual vouchers to determine what is causing the differences; and (3) reconcile the existing differences between the RP and LP. In addition, RIS should implement procedures to prevent future out-of-balance situations.

4. Actuarial Census Data

The Postal Data File (PDF) contains census data for United States Post Office (USPS) retirees, and is used by OPM in the calculation of LP actuarial liabilities at September 30th. Audit procedures performed on the PDF determined that the PDF had not been updated since September 11, 1998, the last submission by USPS before year end. However, a salary increase had occurred on September 12, 1998 and was not reflected in the PDF. While this salary increase was not large enough to materially affect the estimate of the actuarial liability for September 30, 1999, similar timing differences, should they continue to occur, may affect future years' estimations.

Recommendation

We understand USPS normally submits its year end data approximately two to three weeks prior to year end. We recommend OPM perform year end procedures to inquire whether systemic changes are made to the PDF database after the USPS submission, and to request an update to the PDF data if systemic changes have occurred. OPM should also consider whether other agencies may have similar procedures that could affect data in other databases used by OPM to calculate year end actuarial liabilities.

* * * * *

OMB Bulletin No. 98-08, as amended, requires us to compare material weaknesses disclosed during the LP audit with the material weaknesses reported by OPM in its Federal Managers' Financial Integrity Act (FMFIA) report for the audit period. As a result of this comparison, we noted that the substantial nonconformance with FFMIA reported in the *Compliance with Laws and Regulations* section of our report was not included in OPM's fiscal year 1999 FMFIA report.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests of compliance with laws and regulations, exclusive of the FFMIA, performed as part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, disclosed no instances of noncompliance required to be reported herein under *Government Auditing Standards* and OMB Bulletin 98-08, as amended.

Under FFMIA, LP's financial management systems are required to be in substantial conformance with (1) Federal financial management system requirements, (2) Federal accounting standards, and (3) the United States Standard General Ledger (SGL) at the transaction level.

The results of our tests of compliance with FFMIA disclosed instances, described below, where LP's financial management systems did not substantially conform with the requirements discussed in the preceding paragraph:

1. **Federal Financial Management System Requirements**. In accordance with OMB Bulletin No. 98-08, as amended, an agency must meet the following requirements to substantially conform with FFMIA: Federal financial management system requirements; OMB Circular A-127 requirements; requirements published in JFMIP's Federal Financial System Requirements series; and OMB Circular A-130 security requirements. The systems supporting the LP do not meet the following requirements:

   a. *Support the budget execution function and comply with external reporting requirements* – The budgetary account structure for the Federal Financial System (FFS), the core financial management system for the benefit plans, was not implemented as of September 30, 1999. This finding resulted in noncompliance with OMB Circular A-127 and JFMIP's Federal Financial Management Systems Requirements for "Comparability and Consistency," "Application of the SGL at the Transaction Level," "Financial Reporting," and "Support for Budgeting and Performance Reporting."

   b. *Provide adequate system security* – OPM has not performed a security risk assessment within the last three years. However, during that period OPM upgraded the mainframe and networking platforms and implemented a new core financial management system. While OPM plans to perform assessments, they have not been scheduled. In addition, OPM's draft *Information Technology Security Policy* addresses the need for a certification and accreditation process, but there is not one currently in place. Compliance with OMB Circular A-130 is a critical compliance indicator for the FFMIA, and performance of periodic risk assessments is a critical component of achieving compliance with OMB Circular A-130.

2. **Federal Accounting Standards**. OMB Bulletin No. 98-08, as amended, states that FFMIA requires financial information used in the preparation of financial statements to be adequately supported by detailed financial records. Detailed financial records exist for all proprietary accounting information; however, the LP has not yet implemented an accounting structure to support budgetary amounts reported in the LP statements of budgetary resources and financing. The lack of a formal budgetary structure compromises RIS's ability to accurately summarize budgetary data in the LP financial statements.

3. **SGL at the Transaction Level**. OMB Bulletin No. 98-08, as amended, states that FFMIA requires detailed information to be *"captured and summarized so that it follows the SGL descriptions and posting rules and is captured at the level necessary to meet OMB or Treasury reporting requirements and for preparing financial statements."* While detailed records exist for all proprietary accounts, the LP has not implemented an accounting structure to support budgetary amounts reported in the LP financial statements.

Recommendation

To achieve substantial conformance with FFMIA, RIS should implement the budgetary accounting structure of FFS, its core financial management system. RIS should also take actions to address the findings related to systems security required by OMB Circular A-127 and OMB Circular A-130. The resolution of these findings should be a priority for fiscal year 2000.

RESPONSIBILITIES

Management's Responsibility. The Chief Financial Officers (CFO) Act of 1990 requires federal 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 assist OPM in meeting its CFO Act reporting requirements, annual financial statements are prepared for the LP. Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing and maintaining internal control over financial reporting; and
- complying with laws and regulations applicable to the LP, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures.

Auditors' Responsibility. Our responsibility is to express an opinion on the LP financial statements as of and for the year ended September 30, 1999 based on our audit. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 98-08, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinion.

To fulfill these responsibilities, we performed procedures such as the following:

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management; and
- evaluated the overall financial statement presentation.

We are also responsible for considering OPM's internal control over financial reporting related to the LP and testing OPM's compliance with certain provisions of applicable laws and regulations related to the LP that could have a direct and material effect on its 1999 LP financial statements.

In planning and performing our audit, we considered OPM's internal control over financial reporting related to the LP by obtaining an understanding of the agency's significant internal controls, determined whether these internal controls have 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. 98-08, as amended. 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 over financial reporting. Consequently, we do not provide an opinion on internal control.

Our consideration of 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 AICPA and OMB Bulletin 98-08, as amended, and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses.

In addition, we considered the LP's internal control over the information contained in the required supplementary information schedule entitled *Life Insurance Program – Required Supplementary Information*, by obtaining an understanding of the agency's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls, as required by OMB Bulletin 98-08, as amended. Our procedures were not designed to provide assurance on internal control over the required supplementary information, and, accordingly, we do not provide an opinion on such controls.

With respect to internal controls related to performance measures determined by management to be key and reported in the MD&A to the financial statements, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 98-08, as amended. 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.

As part of obtaining reasonable assurance about whether LP's financial statements are free of material misstatement, we performed tests of LP's 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. We also performed tests of LP's compliance with certain other laws, regulations and government-wide policies identified by OMB, as applicable to OPM, including the requirements set forth in FFMIA. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to the LP.

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

Additionally, under FFMIA, we are required to report whether LP's financial management systems substantially conform with (1) Federal financial management system requirements, (2) Federal accounting standards, and (3) the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin No. 98-08, as amended.

DISTRIBUTION

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

KPMG LLP

February 11, 2000
Washington, D.C.

FINANCIAL STATEMENTS
FISCAL YEAR
1997

U.S. OFFICE OF PERSONNEL MANAGEMENT

KPMG Peat Marwick LLP

2001 M Street, N.W.
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

Director, U.S. Office of Personnel Management:

We have audited the accompanying 1997 financial statements of the Retirement Program (RP), administered by the U.S. Office of Personnel Management (OPM) Retirement and Insurance Service (RIS). In our opinion, based on our audit, the 1997 RP financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described in Note 1 to the financial statements.

In connection with our audit and in accordance with *Government Auditing Standards*, we also considered OPM's internal controls over financial reporting related to the RP and tested OPM's compliance with certain provisions of applicable laws and regulations related to the RP that could have a direct and material effect on its 1997 financial statements.

As a result of our consideration of internal control over financial reporting, we identified the following reportable conditions:

1. Controls over contributions revenue;
2. Cash management - investments;
3. System Development Life Cycle (SDLC) for major systems implementation efforts;
4. Financial reporting, policies and procedures;
5. Controls over system software;
6. Comprehensive computer system and application risk assessments; and,
7. Controls over benefit payments made to annuitants.

We consider the first four reportable conditions, above, to be material weaknesses.

As a result of our tests of compliance with certain provisions of applicable laws and regulations, we noted no instances of noncompliance that would be reportable under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*, as amended. In the compliance section, below, we identify differences in material weaknesses identified by OPM in its Federal Managers' Financial Integrity Act (FMFIA) report, and those identified in our evaluation of RP's internal controls. In addition, the compliance section identifies noncompliance with Federal system requirements and the U.S. Standard General Ledger, described in the Federal Financial Management Improvement Act (FFMIA).

The results of our audit of the 1997 RP financial statements, our consideration of internal control over financial reporting, our tests of OPM's compliance with certain provisions of applicable laws and regulations related to the RP, and our responsibilities, are discussed in the remainder of this report.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying statement of financial position of the RP as of September 30, 1997, and the related statements of operations and changes in net position and cash flows for the year then ended. These financial statements are the responsibility of OPM's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 93-06, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance that 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 audit provides a reasonable basis for our opinion.

As described in Note 1, these financial statements were prepared in conformity with the hierarchy of accounting principles and standards recommended by the principals of the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, based on our audit, the 1997 financial statements referred to above present fairly, in all material respects, the financial position of RP as of September 30, 1997, and the results of its operations and changes in net position and cash flows for the year then ended, in conformity with the basis of accounting described in Note 1 to the financial statements.

As discussed in Note 1 to the financial statements, RP implemented Statement of Federal Financial Accounting Standards No. 1, *Accounting for Selected Assets and Liabilities*, and Statement of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*, effective October 1, 1996.

Our audit was conducted for the purpose of forming an opinion on the RP's financial statements, taken as a whole. The information in the Overview section entitled *The Retirement Program* contains a wide range of data, some of which is not directly related to the RP financial statements. The information in the Overview is not a required part of the financial statements but is supplementary information required by OMB Bulletin Nos. 94-01 and 97-01, *Form and Content of Agency Financial Statements*. We have considered whether this information is materially inconsistent with the principal financial statements. Such information has not been subjected to the procedures applied in the audit of the financial statements. Accordingly, we express no opinion on it.

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of OPM is responsible for establishing and maintaining internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that:

- transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements;

- funds, property, and other assets are safeguarded against loss from unauthorized use or disposition;

- transactions are executed in accordance with management's authorization and are properly recorded and accounted for to permit the preparation of reliable financial reports in conformity with applicable accounting principles described in Note 1 to the financial statements, and to maintain accountability over the assets; and,

- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Because of inherent limitations in internal controls, misstatements may nevertheless occur and not be detected. Also, projection of an evaluation of internal controls to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit, we considered OPM's internal control over financial reporting for the RP in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements, and not to provide an opinion on the internal control over financial reporting. Accordingly, we do not express such an opinion. With respect to internal controls, we obtained an understanding of the design of relevant policies and procedures, determined if they had been placed in operation, assessed control risk, and performed tests of internal controls.

Our evaluation of the controls for performance information was limited to those controls designed to ensure the existence and completeness of the information. With respect to the performance measures control objectives, we obtained an understanding of relevant internal control policies and procedures designed to permit the preparation of reliable and complete performance information, and we assessed control risk.

Reportable conditions are matters coming to our attention that represent significant deficiencies in the design or operation of internal control that could adversely affect the RP's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A material weakness is a condition 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, or material to performance measures or aggregate of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted certain matters involving internal controls over financial reporting and their operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and by OMB Bulletin 93-06, as amended.

Our consideration of internal control would not necessarily disclose all internal control matters that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. However, we noted the following weaknesses in internal control over financial reporting that we consider to be reportable conditions. We considered the first four reportable conditions to be material weaknesses.

1. Controls Over Contributions Revenue

OPM has delegated responsibility to the employer agencies for (1) collection of contributions revenue from participants, (2) determination of an agency's contribution, (3) certification of employee eligibility for benefits, and (4) maintenance of supporting records. Establishing and maintaining adequate internal controls for transactions and testing the effectiveness of those internal controls are the employer agencies' responsibilities. OPM, as administrator, is dependent on the employer agencies for the accuracy and completeness of the data. OPM has prescribed minimum records, documentation and reconciliation requirements to the employer agencies, but does not monitor the effectiveness of employer agencies' controls or their degree of compliance with controls. As a result, OPM does not have a basis for relying on other agency internal controls as they relate to contributions recorded in its accounting records and other data received which support amounts recorded in the financial statements.

In addition, OPM does not have policies and procedures that provide for internal control and financial management over the contributions revenue collected from the employer agencies. Specifically, OPM has not implemented ongoing monitoring and review procedures to verify the accuracy and completeness of amounts received and recorded in its records, or implemented other compensating controls.

Recommendation

As noted in our prior year report, we continue to recommend OPM establish an ongoing monitoring and review program over agency payroll office procedures and data reported and remitted to OPM, as a means of ensuring the accuracy and completeness of amounts recorded in its financial records.

2. Cash Management - Investments

OPM does not have adequate procedures for (1) authorizing and approving investment transactions, and (2) ensuring that the maximum and correct amounts available are invested timely. We noted a number of instances where Fund Balance with Treasury was over- or under-invested during fiscal year 1997. In one such instance, the over-invested balance was approximately $300 million. There were other instances where interest payments made by Treasury were not invested timely. In addition, OPM's investment ledger (intended to track transactions) was not complete, was not reviewed by a supervisor, and was not reconciled timely to balances in the general ledger.

Recommendation

OPM is installing a new core financial management system, which includes a separate investment module, and has obtained the services of a contractor to develop related policies and procedures. However, until implementation is complete, as noted in our prior year report, we continue to recommend OPM establish procedures that provide for (1) the preparation of cash management schedules that support the amount and timing of investment transactions, (2) documentation of reviews and authorizations of investment transactions, and (3) verification of the accuracy of schedules and balances, before amounts are invested.

3. System Development Life Cycle for Major Systems Implementation Efforts

OPM does not have a System Development Life Cycle (SDLC) for major systems implementation efforts. Without a SDLC, the development of systems is not coordinated with organizational strategic plans and goals and may result in the acquisition of technology that does not provide overall desired benefits for OPM at the organizational level.

Recommendation

As noted in our prior year report, we continue to recommend that OPM implement a SDLC which includes a needs analysis, systems design, and guidance for implementation, operations, and maintenance. This will provide OPM with a mechanism to help ensure that its business needs are addressed, costs are managed, deadlines are established, and management requirements for application controls are satisfied. We understand that OPM's plan requires involvement of users, including other agencies, and that it needs to be integrated across the agency as a whole.

4. Financial Reporting, Policies and Procedures

RIS' financial reporting responsibilities and policy-making should be enhanced to provide clearer integration of operational objectives with management and employee responsibilities. RIS's mission statement needs to thoroughly incorporate financial reporting and policy objectives which are consistent with its fiduciary responsibilities as administrator of the RP. Furthermore, departmental and individual financial responsibilities do not incorporate policies and procedures designed to monitor and ensure accuracy and completeness of financial activities of the RP.

(a) Financial management plan

RIS is responsible for administering and managing the RP, including managing contributions received, determining and paying benefits, maintaining accurate benefit records, providing retirement support services, and developing legislative initiatives for the RP. RIS has made progress in developing financial management policies to fulfill these responsibilities, but has not yet achieved full implementation. Accordingly, weaknesses in internal controls and accounting systems within OPM for the RP continue.

Recommendation

We recommend that RIS fully implement RP's financial management plan. The implementation of the plan will form an internal control structure for financial management and reporting.

(b) Financial management reengineering

OPM's processes and systems have evolved over a long period of time and have changed to address specific issues or weaknesses in individual processes or systems, without necessarily assessing macro level effects. Therefore, OPM and the RP operate in a paper and process intensive environment with numerous non-integrated information systems. Although QIT's (quality improvement teams) were established by OPM to focus on financial system reengineering efforts, only limited progress has been made by the teams during fiscal year 1997.

Recommendations

- OPM's current Financial Management Status Report & Five-Year Plan includes plans to reengineer the retirement processing system based on identified requirements. As noted in our prior year report, we recommend the RP Status Report and Five-Year Plan include a concerted effort to make fundamental changes to all processes affecting all disciplines and user groups. To be effective, this plan must address the effects of and interactions among human resources, technology and facilities. The focus of this effort should be directed at determining the minimum processes necessary to achieve the desired results, while maintaining an adequate system of controls.

- As we recommended last year, the cost of control processes should also be weighed against benefits achieved. We recommend that RIS continue to develop action plans for reengineering and streamlining its financial operations and make changes to processes to eliminate redundancies, unnecessary approvals, and extraneous records.

- RIS should carry out its current plans to overhaul core program and financial systems so they will support the RP's mission of improving customer service and satisfaction. OPM should continue to improve its financial management systems by establishing fixed time frames and action plans. Once established. OPM should aggressively monitor the plans and time frames.

5. Controls over System Software

The operating system's (IBM OS/390) primary integrity mechanism, Authorized Program Facility (APF), is not being properly controlled. Any program with APF authority has the ability to access all data files available to the OS/390 operating system and bypass IBM's access control software, Resource Access Control Facility (RACF). In addition, the system software administrative group, not the Security Administration, is currently the owner of the RACF data set. Consequently, there is a risk that unauthorized users can bypass RACF checking and perform sensitive security tasks, alter data integrity and/or control the operating system.

Recommendation

OPM management should develop APF administration policies and procedures to ensure compliance with IBM's integrity rules for all IBM operating systems. OPM should examine access privileges to APF libraries and determine if the current number of personnel with this level of access is necessary. In addition, the ownership and access rights to the RACF data set should be reevaluated.

6. Comprehensive Computer System and Application Risk Assessments

OPM has not conducted a comprehensive risk assessment of computer systems and applications. Risk assessments increase the likelihood that security policies and procedures are being made regarding which risks to accept and which to mitigate through security controls.

Recommendation

OPM should develop a process for ensuring that the assessment of risk is an on-going process, and formal risk assessments are used in the development of security policies and procedures.

7. Controls Over Benefit Payments Made To Annuitants

Despite the current controls in place over benefit payments, errors continue to occur in benefit computations. OPM should enhance controls over benefit payments made to annuitants in order to reduce the likelihood of errors in benefit calculations. The Office of Retirement Programs (ORP) has not established consistent procedures and training across departments to collect data related to the occurrence of errors found during the adjudication process. In addition, detail data of the results from adjudication (e.g., errors found as part of review of benefit specialists work) performed throughout the year are not accumulated and reported to management for analysis on a periodic basis.

Recommendation

OPM should evaluate the acceptability of error rates in benefit payment calculations and expand reviews and procedures until an acceptable level is achieved. The accuracy of annuitant files should be reviewed by the Quality Assurance Division (QAD) from the inception of an annuitants' employment, not just from the last adjudication or post-adjudication date. The increase in reliability of benefit payment controls gained by a more comprehensive file review will outweigh the incremental cost in QAD labor hours incurred to perform the reviews.

As a by-product of the file reviews, we recommend OPM create data collection procedures, to gather information on case adjudication, and perform an analyses of the data to determine where errors are occurring and whether procedural changes will eliminate these errors. We recommend OPM collect, at a minimum, the following data:

- number and description of errors found;
- cause of errors (e.g., keypunch, misinterpretation of legislation); and,
- timing of the errors (e.g., initial adjudication, post-adjudication).

Data analyses should include, but should not be limited to, the following:

- identification of time periods of large or unusual error occurrences;
- an indication of what stage of the process the errors occur (e.g., initial stage or during adjudication process);
- the types and frequencies of errors; and,
- a determination of the underlying cause of the errors.

Error information, including suggestions to avoid future errors, should continue to be communicated to the benefit specialist or reviewer who made the error. In addition, the results of the data analysis should be used to facilitate future training programs. These training programs should reinforce the importance of thorough and accurate reviews of retirement case files and benefit payment calculations prior to the payment of benefits, and should include procedures for informing reviewers of errors and necessary corrective actions. The content of the training courses should include a refresher course on the application of new laws and regulations affecting the adjudication process. The training program should also specify a minimum level of annual training for all benefit specialists and others involved in reviewing case files and should be consistent across all departments in the Office of Retirement Programs.

* * * * * *

These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the RP financial statements as of and for the year ended September 30, 1997.

We also noted other matters involving internal control over financial reporting and its operation that we do not consider to be reportable conditions that we have reported to the management of OPM in a separate letter dated February 27, 1998.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

The management of OPM is responsible for complying with laws and regulations applicable to the RP. As part of obtaining reasonable assurance about whether RP's financial statements are free of material misstatement, we performed tests of OPM's 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 other laws and regulations specified in OMB Bulletin No. 93-06, as amended, including the requirements referred to in the Federal Financial Management Improvement Act of 1996. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit. Accordingly, we do not express such an opinion.

The results of our tests of compliance, performed as part of obtaining reasonable assurance about whether the RP financial statements are free of material misstatement, disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin 93-06, as amended.

Federal Managers' Financial Integrity Act (FMFIA) With respect to FMFIA compliance, OMB Bulletin 93-06, as amended, requires OPM's independent auditors to report if there is a conflict between the agency's most recent FMFIA report and the auditors' evaluation of internal control over financial reporting based on their audit of the program's financial statements. Accordingly, as a part of our audit, we obtained an understanding of OPM's process for evaluating and reporting on internal control and accounting systems as required by the FMFIA and compared the OPM's 1997 FMFIA report results to the results of our evaluation of internal control.

In the internal control section of this report, we reported the System Development Life Cycle for major systems implementation efforts as a material internal control weakness which was not identified by OPM management as a weakness in the 1997 FMFIA report.

Federal Financial Management Improvement Act (FFMIA) OMB Bulletin 93-06, as amended, requires OPM's independent auditors to report whether OPM's financial management systems substantially comply with (1) Federal financial management system requirements, (2) applicable accounting standards, and (3) the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997.

The results of our tests disclosed instances, described below, where OPM's financial management systems did not substantially comply with the requirements discussed in the preceding paragraph:

- OPM has identified their core financial management system integration as a material non-conformance in its FMFIA report.

- The core financial management system is not compliant with the United States Standard General Ledger at the transaction level (i.e., subledgers do not process transactions consistent with SGL account description and posting requirements).

- OPM's financial management system does not support all program decision making. The system does not produce cost reports or other types of reports at meaningful levels.

OPM is in the process of implementing a new core financial management system, which is scheduled to be fully implemented by 1999, and anticipates the new system will resolve the above instances of FFMIA noncompliance.

An audit of financial statements conducted in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin 93-06, as amended, was not designed to and does not provide any assurance that Year 2000 issues which may exist have been identified, on the adequacy of OPM's remediation plans related to Year 2000 financial or operational issues, or on whether OPM is or will become Year 2000 compliant. Further, we have no responsibility with regard to OPM's efforts to make its systems, or any other systems, such as those of OPM's vendors, service providers, or any other third parties Year 2000 compliant, or provide assurance on whether OPM has addressed or will be able to address all of the affected systems on a timely basis. These are responsibilities of OPM's management.

Recommendation

In addition to implementing the recommendations to improve internal controls, identified in the internal control section of our report, we recommend OPM allocate the necessary budgetary and staffing resources to ensure timely implementation of the new core financial management system. This action is in progress. We also recommend OPM develop an effective self-assessment process to ensure compliance with all Federal financial management system requirements.

* * * * * *

We also noted other matters involving compliance with laws and regulations that we do not consider to be material noncompliance related to RP that we have reported to the management of OPM in a separate letter dated February 27, 1998.

Distribution

This report is intended for the information of OPM's management, OPM's Office of the Inspector General, and the U.S. Congress. However, this report is a matter of public record and its distribution is not limited.

KPMG Peat Marwick LLP

February 27, 1998

KPMG Peat Marwick LLP

2001 M Street, N.W.
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

Director, U.S. Office of Personnel Management:

We were engaged to audit the accompanying 1997 financial statements of the Health Benefits Insurance Program (HBP), administered by the U.S. Office of Personnel Management (OPM) Retirement and Insurance Service (RIS). As a result of our engagement to audit the HBP financial statements as of and for the year ended September 30, 1997, we were unable to satisfy ourselves as to fairness of the premiums paid to insurers and experience rated carrier (ERC) activity and balances recorded in the HBP financial statements. Because of this and other related matters, which are discussed further in the following section, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying HBP financial statements as of and for the year ended September 30, 1997.

In connection with our engagement to audit and in accordance with *Government Auditing Standards*, we also considered OPM's internal controls over financial reporting related to the HBP and tested OPM's compliance with certain provisions of applicable laws and regulations related to the HBP that could have a direct and material effect on its 1997 financial statements.

As a result of our consideration of internal control over financial reporting, we identified the following reportable conditions:

1. Controls over contributions revenue;
2. Cash management - investments;
3. System Development Life Cycle (SDLC) for major systems implementation efforts;
4. Financial reporting, policies and procedures;
5. Controls over insurance premiums;
6. Reconciliation of inter-program transactions;
7. Controls over system software; and
8. Comprehensive computer system and application risk assessments.

We consider the first five reportable conditions to be material weaknesses.

As a result of our tests of compliance with certain provisions of applicable laws and regulations, we noted no instances of noncompliance that would be reportable under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*, as amended. In the compliance section, below, we identify differences in material weaknesses identified by OPM in its Federal Managers' Financial Integrity Act (FMFIA) report, and those identified in our evaluation of HBP's internal controls. In addition, the compliance section identifies noncompliance with Federal systems requirements, the U.S. Standard General Ledger, and Federal accounting requirements, described in the Federal Financial Management Improvement Act (FFMIA).

The results of our audit of the 1997 HBP financial statements, our consideration of internal control over financial reporting, our tests of OPM's compliance with certain provisions of applicable laws and regulations related to the HBP, and our responsibilities, are discussed in the remainder of this report.

DISCLAIMER OF OPINION ON FINANCIAL STATEMENTS

We were engaged to audit the accompanying statement of financial position of the HBP as of September 30, 1997, and the related statements of operations and changes in net position and cash flows for the year then ended. These financial statements are the responsibility of OPM's management.

As described in Note 1, these financial statements were prepared in conformity with the hierarchy of accounting principles and standards recommended by the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

The majority of benefits provided through the HBP are administered primarily by experience-rated carriers (ERCs), which charge insurance premiums to the HBP based on actual claims experience. Approximately 8% of the total assets and approximately 74% of the total premium expenses reflected in the financial statements of the HBP represent transaction activity with ERCs. Each ERC is required to maintain separate accounts for HBP activities and submit an annual statement (generally unaudited) of its HBP operating activities, which is used by OPM for recording ERC transactions in HBP's financial statements. OPM does not have an adequate control system over the activity (claims for reimbursements) and balances reported by the ERCs and included in the financial statements of the HBP. In addition, OPM does not maintain records or support for premium amounts paid to other health insurers. Adequate evidential matter was not available to support transactions and balances related to insurance premiums and activities of ERCs and other health insurers. It was not practicable to extend our auditing procedures to satisfy ourselves as to the fairness of the balances in ERC reserves of $733 million, the post-retirement liability of approximately $159 billion and the related cumulative effect of a change in accounting principle of approximately $148 billion, premiums payable of $3.0 billion, the losses of ERCs of $1.4 billion, post retirement benefits expense of approximately $16 billion and premiums expenses of approximately $9 billion, included in the accompanying HBP financial statements as of and for the year ended September 30, 1997. Such amounts enter into the determination of net position, changes in net position, and cash flows.

Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying HBP financial statements as of and for the year ended September 30, 1997.

As discussed in Note 1 to the financial statements, OPM implemented Statement of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*, effective October 1, 1996.

The supplementary information captioned *Supplemental Schedule of Financial Position* and *Supplemental Schedule of Operations and Changes in Net Position* is presented for purposes of additional analysis and is not a required part of the HBP financial statements. The supplementary information has been subjected to the procedures applied in the engagement to audit the HBP financial statements. We are unable to express, and we do not express, an opinion on this supplementary information, for the reasons explained in the third preceding paragraph.

The information in the Overview section entitled *The Health Benefits Program* contains a wide range of data, some of which is not directly related to the HBP financial statements. The information in the Overview is not a required part of the financial statements but is supplementary information required by OMB Bulletin 94-01 and 97-01, *Form and Content of Agency Financial Statements*. We have considered whether the information is materially inconsistent with the principal financial statements. Such information has not been subjected to the procedures applied in our engagement to audit the financial statements and, accordingly, we express no opinion on it.

REPORT ON INTERNAL CONTROLS OVER FINANCIAL REPORTING

The management of OPM is responsible for establishing and maintaining internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that:

- transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements;
- funds, property, and other assets are safeguarded against loss from unauthorized use or disposition;
- transactions are executed in accordance with management's authorization and are properly recorded and accounted for to permit the preparation of reliable financial reports in

conformity with applicable accounting principles described in Note 1 to the financial statements, and to maintain accountability over the assets; and

- data that supports reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Because of inherent limitations in internal controls, misstatements may nevertheless occur and not be detected. Also, projection of an evaluation of internal controls to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our engagement, we considered OPM's internal control over financial reporting for HBP in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements, and not to provide an opinion on the internal control over financial reporting. Accordingly, we do not express such an opinion. With respect to internal controls, we obtained an understanding of the design of relevant policies and procedures, determined if they had been placed in operation, assessed control risk, and performed tests of internal controls.

Our evaluation of the controls for performance information was limited to those controls designed to ensure the existence and completeness of the information. With respect to the performance measures control objectives, we obtained an understanding of relevant internal control policies and procedures designed to permit the preparation of reliable and complete performance information, and we assessed control risk.

Reportable conditions are matters coming to our attention that represent significant deficiencies in the design or operation of internal control that could adversely affect the HBP's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A material weakness is a condition 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, or material to a performance measure or aggregate of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted certain matters involving internal controls over financial reporting and their operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 93-06, as amended.

Our consideration of internal control would not necessarily disclose all internal control matters that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. However, we noted the following weaknesses in internal control over financial reporting that we consider to be reportable conditions. We consider the first five reportable conditions to be material weaknesses.

1. Controls over Contributions Revenue

OPM has delegated responsibility to the employer agencies for (1) collection of contributions revenue from participants, (2) determination of an agency's contribution, (3) certification of employee eligibility for benefits, and (4) maintenance of supporting records. Establishing and maintaining adequate internal controls for transactions and testing the effectiveness of those internal controls are the employer agencies' responsibilities. OPM, as administrator, is dependent on the employer agencies for the accuracy and completeness of the data. OPM has prescribed minimum records, documentation and reconciliation requirements to the employer agencies, but does not monitor the effectiveness of employer agencies' controls or their degree of compliance with controls. As a result, OPM does not have a basis for relying on other agency internal controls as they relate to contributions recorded in its accounting records and other data received which support amounts recorded in the financial statements.

In addition, OPM does not have policies and procedures that provide for internal control and financial management over the contributions revenue collected from the employer agencies. Specifically, OPM has not implemented ongoing monitoring and review procedures to verify the accuracy and completeness of amounts received and recorded in its records, or implemented other compensating controls.

Recommendation

As noted in our prior year report, we continue to recommend OPM establish an ongoing monitoring and review program over agency payroll office procedures and data reported and remitted to OPM, as a means of ensuring the accuracy and completeness of amounts recorded in its financial records. OPM advises that they are exploring alternatives to mitigate this weakness through additional interagency cooperative efforts.

2. Cash Management - Investments

OPM does not have adequate procedures for (1) authorizing and approving investment transactions, and (2) ensuring that the maximum and correct amounts available are invested timely. We noted a number of instances where Fund Balance with Treasury was over- or under-invested during fiscal year 1997. In one such instance, the under-invested balance was approximately $500 million. There were other instances where interest payments made by Treasury were not invested timely. In addition, OPM's investment ledger (intended to track transactions) was not complete, was not reviewed by a supervisor, and was not reconciled timely to balances in the general ledger.

Recommendation

OPM is installing a new core financial management system, which includes a separate investment module, and has obtained the services of a contractor to develop related policies and procedures. However, until implementation is complete, as noted in our prior year report, we continue to recommend OPM establish procedures that provide for (1) the preparation of cash management schedules that support the amount and timing of investment transactions, (2) documentation of reviews and authorizations of investment transactions, and (3) verification of the accuracy of schedules and balances, before amounts are invested.

3. System Development Life Cycle (SDLC) For Major Systems Implementation Efforts

OPM does not have a System Development Life Cycle (SDLC) for major systems implementation efforts. Without a SDLC, the development of systems is not coordinated with organizational strategic plans and goals and may result in the acquisition of technology that does not provide the overall desired benefits for OPM at the organizational level.

Recommendation

As noted in our prior year report, we continue to recommend that OPM implement a SDLC which includes a needs analysis, systems design, and guidance for implementation, operations, and maintenance. This will provide OPM with a mechanism to help ensure that its business needs are addressed, costs are managed, deadlines are established, and management requirements for application controls are satisfied. We understand that OPM's plan requires involvement of users, including other agencies, and that it needs to be integrated across the agency as a whole.

4. Financial Reporting, Policies and Procedures

RIS's financial reporting responsibilities and policy-making should be enhanced to provide clearer integration of operational objectives with management and employee responsibilities. RIS' mission statement needs to thoroughly incorporate financial management objectives which are consistent with its fiduciary responsibilities as administrator of the HBP. Furthermore, departmental and individual financial management responsibilities do not incorporate policies and procedures designed to monitor and ensure accuracy and completeness of financial reporting of the HBP.

(a) Financial management plan

RIS is responsible for administering and managing the HBP, including managing contributions received, determining and paying benefits, maintaining accurate benefit records, providing health benefit support services, and developing legislative initiatives for the HBP. RIS has made progress in developing financial management policies to fulfill these responsibilities, but has not yet achieved full implementation. Accordingly, weaknesses in internal controls and accounting systems within OPM for the HBP continue.

Recommendation

We recommend that RIS fully implement HBP's financial management plan. The implementation of the plan will form an internal control structure for financial management and reporting.

(b) Financial management performance measures

During 1997, OPM's strategic plan was enhanced to place an emphasis on achieving improved financial management within the benefit programs. However, based on our interpretation of the requirements of the Government Performance and Results Act (GPRA), some of RIS' key financial performance indicators will not adequately measure HBP's success toward achieving this goal. For instance, according to OPM's 1999 annual performance plan, a key performance indicator that will be used to measure the success of improving insurance carrier financial reporting and performance is: *"Program financial decision-making, including rate-setting, can occur with increased confidence in the information provided by the experience-rated carriers."* It is not clear how *increased confidence* will be practically and objectively measured.

Recommendation

We recommend RIS refine its critical objectives and key performance indicators relating to the financial management of the HBP. Clear, concise objectives and measures will ensure adequate control over the HBP funds.

(c) Financial management reengineering

OPM's processes and systems have evolved over a long period of time, and have changed to address specific issues or weaknesses in individual processes or systems, without necessarily assessing macro level effects. Therefore, OPM and the HBP operate in a paper and process intensive environment with numerous non-integrated information systems. Although QITs (quality improvement teams) were established by OPM to focus on financial system reengineering efforts, only limited progress has been made by the teams during fiscal year 1997.

Recommendations

- OPM's current Financial Management Status Report & Five-Year Plan includes plans to reengineer the retirement processing system based on identified requirements. The Business Reengineering Program also includes some requirements to be instituted for the HBP. As noted in our prior year report, we recommend the HBP Status Report and Five-Year Plan include a concerted effort to make fundamental changes to all processes affecting all disciplines and user groups. To be effective, this plan must address the effects of and interactions among human resources, technology and facilities. The focus of this effort should be directed at determining the minimum processes necessary to achieve the desired results, while maintaining an adequate system of controls.

- As we recommended last year, the cost of control processes should also be weighed against benefits achieved. We recommend RIS continue to develop action plans for reengineering and streamlining its financial operations and make changes to processes to eliminate redundancies, unnecessary approvals, and extraneous records.

- RIS should carry out its current plans to overhaul core program and financial systems so they will support the HBP's mission of improving customer service and satisfaction. OPM should continue to improve its financial management systems by establishing fixed time frames and action plans. Once established, OPM should aggressively monitor the plans and time frames.

5. Controls over Insurance Premiums

(a) Premiums expense controls

RIS does not have an adequate system to ensure the accuracy, propriety and completeness of premiums paid and payable to carriers, nor does RIS have an ongoing periodic review (audit) of agencies enrollment reconciliations to ensure premiums and claims are paid for valid subscribers.

Community rated carriers. OPM remits premium payments to community rated carriers (CRCs) based on bi-weekly amounts it receives from employer agencies. RIS has not implemented all of the necessary procedures to verify the accuracy and completeness of amounts paid to the CRCs. The procedures performed by employer agencies are not regularly monitored by RIS to ensure that enrollees/subscribers records reflect accurate information. RIS relies on the OIG's audits of the health insurance carriers to ensure the validity of claims and subscribers; however, the OIG audits do not occur often enough for improper claim payments to be recovered because the statute of limitation has expired.

Experience rated carriers (ERCs). OPM disburses premiums to experience rated carriers (ERCs) based on claims paid by the ERCs to federal subscribers. An ERCs annual premium is based primarily on its claims expense. ERCs are reimbursed by OPM through a letter of credit (LOC), which is funded with employee and employer contributions received by OPM for the plan. The ERCs do not submit documentation for the claims paid through the LOC.

RIS does not have a reporting system to monitor payments made to either ERCs or CRCs. The Excessive Difference Report details prior premium payments, current premium payments, and dollar and percentage differences for each carrier. However, there are no established policies and procedures for using the Excessive Difference Report to investigate and resolve significant item differences. Additionally, there is no routine, systematic process to audit or review claims paid by carriers for allowability under the contract.

Recommendation

As noted in our prior year report, we continue to recommend that OPM:

- Continue to monitor employer agencies' conformity with HBP compliance requirements. RIS established a system to ensure federal employer agencies reconcile their health benefit enrollees from their payroll records to the premiums HBP pays to CRCs. RIS reissued written communication to federal agency payroll offices reminding them to provide carriers with the names of enrollees for reconciliation procedures, and RIS developed and distributed an audit guide for agency personnel and payroll offices. RIS should ensure compliance with these procedures by performing regularly scheduled compliance reviews.

- Expand the ongoing audit process to provide more frequent coverage of claims paid by ERCs. The fiscal year 1999 annual performance plan for RIS includes "validating compliance with Federal Employee Health Benefit (FEHB) contract provisions through regular financial and performance audits" as a means of ensuring compliance, but neither the strategic plan nor the annual performance plan establishes a specific schedule and time frames for future evaluations, as required by GPRA.

(b) ERC reporting controls

Each ERC is encouraged to submit an audited calendar year Annual Accounting Statement (AAS) of HBP operating results, financial position, program statistical data, and other information. Each ERC also provides the HBP with financial, statistical, and other information as of the twelve-month period ended September 30, in an unaudited abbreviated format which is used by OPM for the HBP financial statements. The activity and balances reported in the AAS are not reconciled to transactions on the books of the HBP or used as part of the annual financial reporting process, and the September 30 information is not reconciled to the AAS or other audited information.

OPM sent a draft of the FEHB Plan Audit Guide to all ERCs in November 1997, describing the development and implementation of the Guide. Beginning with fiscal year 1997, the Guide requires carriers to submit to OPM calendar year audited financial statements, an accompanying management letter, and a fiscal year agreed-upon procedures report on OPM contract compliance, as prepared by independent auditors. Two carriers agreed to act as pilots to perform these procedures for fiscal year 1997. One carrier completed their procedures in November 1997 and the other was scheduled to be completed by the end of January 1998. This Audit Guide is still in the early stages of implementation.

Recommendation

As noted in our prior year report, we continue to recommend OPM increase its efforts to require ERCs to submit audited financial information and agreed-upon procedure reports, as described in the ERC Audit Guide. The 1999 fiscal year annual performance plan acknowledges this process as a means to achieving contract compliance by FEHB carriers. RIS should continue to refine its Audit Guide based on the results of the pilot programs and feedback from its ERC carriers, with the goal of full implementation for fiscal year 1998.

6. Reconciliation of Inter-Program Transactions

Health insurance premiums are withheld from annuitant payments in the RP. The RP is responsible for transferring the amounts to the HBP. However, the source information used to record the entry in the RP is not the same source information used to record the entry in the HBP. OPM has not established adequate monthly reconciliation procedures to ensure all activity occurring between the programs is complete and accurate, and at year end, an out of balance condition existed between the programs.

Recommendation

As noted in our prior year report, we continue to recommend that OPM establish procedures to reconcile monthly activity between the RP and HBP, and record entries in each program from the same source information.

7. Controls over System Software

The operating system's (IBM OS/390) primary integrity mechanism, Authorized Program Facility (APF), is not being properly controlled. Any program with APF authority has the ability to access all data files available to the OS/390 operating system and bypass IBM's access control software, Resource Access Control Facility (RACF). In addition, the system software administrative group, not the Security Administration, is currently the owner of the RACF data set. Consequently, there is a risk that unauthorized users can bypass RACF checking and perform sensitive security tasks, alter data integrity and/or control the operating system.

Recommendation

OPM management should develop APF administration policies and procedures to ensure compliance with IBM's integrity rules for all IBM operating systems. OPM should examine access privileges to APF libraries and determine if the current number of personnel with this level of access is necessary. In addition, the ownership and access rights to the RACF data set should be reevaluated.

8. Comprehensive Computer System and Application Risk Assessments

OPM has not conducted a comprehensive risk assessment of computer systems and applications. Risk assessments increase the likelihood that security policies and procedures are being made regarding which risks to accept and which to mitigate through security controls.

Recommendation

OPM should develop a process for ensuring that the assessment of risk is an on-going process, and that formal risk assessments are used in the development of security policies and procedures.

* * * * *

These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our engagement to audit the HBP financial statements as of and for the year ended September 30, 1997.

We also noted other matters involving internal control and its operation that we do not consider to be reportable conditions that we have reported to the management of OPM in a separate letter dated February 27, 1998.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

The management of OPM is responsible for complying with laws and regulations applicable to the HBP. As part of obtaining reasonable assurance about whether HBP's financial statements are free of material misstatement, we performed tests of OPM's 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 other laws and regulations specified in OMB Bulletin No. 93-06, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit. Accordingly, we do not express such an opinion.

The results of our tests of compliance, performed as part of obtaining reasonable assurance about whether the HBP financial statements are free of material misstatement, disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin 93-06, as amended.

Federal Managers' Financial Integrity Act (FMFIA) With respect to FMFIA compliance, OMB Bulletin 93-06, as amended, requires OPM's independent auditors to report if there is a conflict between the agency's most recent FMFIA report and the auditors' evaluation of internal control over financial reporting based on their audit of the program's financial statements. Accordingly, as a part of our engagement, we obtained an understanding of OPM's process for evaluating and reporting on internal control and accounting systems as required by the FMFIA and compared the OPM's 1997 FMFIA report results to the results of our evaluation of internal control.

In the internal control section of this report, we reported the System Development Life Cycle for major systems implementation efforts as a material internal control weakness which was not identified by OPM management as a weakness in the 1997 FMFIA report.

Federal Financial Management Improvement Act (FFMIA) OMB Bulletin 93-06, as amended, requires OPM's independent auditors to report whether OPM's financial management systems substantially comply with (1) Federal financial management system requirements, (2) applicable accounting standards, and (3) the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997.

The results of our tests disclosed instances, described below, where OPM's financial management systems did not substantially comply with the requirements discussed in the preceding paragraph:

- OPM has identified their core financial management system integration as a material non-conformance in its FMFIA report.

- The core financial management system is not compliant with the United States Standard General Ledger at the transaction level (i.e., subledgers do not process transactions consistent with SGL account description and posting requirements).

- OPM's financial management system does not support all program decision making. The system does not produce cost reports or other types of reports at meaningful levels.

OPM is in the process of implementing a new core financial management system, which is scheduled to be fully implemented by 1999, and anticipates the new system will resolve the above instances of FFMIA noncompliance.

Further, OPM continues to have a material weakness in internal controls relating to activity reported by ERCs and recorded in their financial statements. This condition is an indication of noncompliance with applicable Federal accounting standards.

An audit of financial statements conducted in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Bulletin 93-06, as amended, was not designed to and does not provide any assurance that Year 2000 issues which may exist have been identified, or the adequacy of OPM's remediation plans related to Year 2000 financial or operational issues, or on whether OPM is or will become Year 2000 compliant. Further, we have no responsibility with regard to OPM's efforts to make its systems, or any other systems, such as those of OPM's vendors, service providers, or any other third parties Year 2000 compliant, or provide assurance on whether OPM has addressed or will be able to address all of the affected systems on a timely basis. These are responsibilities of OPM's management.

Recommendation

In addition to implementing the recommendations to improve internal controls, identified in the internal controls section of our report, we recommend OPM allocate the necessary budgetary and staffing resources to ensure timely implementation of the new core financial management system. (This action is in progress.) We also recommend OPM develop an effective self-assessment process to ensure compliance with all Federal financial management system requirements.

We further recommend OPM's RIS program implement internal control procedures over financial reporting information produced by the health benefit carriers, to ensure the accuracy of HBP financial statements.

* * * * *

We also noted other matters involving compliance with laws and regulations that we do not consider to be material noncompliance related to HBP that we have reported to the management of OPM in a separate letter dated February 27, 1998.

Distribution

This report is intended for the information of OPM's management, OPM's Office of the Inspector General, and the U.S. Congress. However, this report is a matter of public record and its distribution is not limited.

KPMG Peat Marwick LLP

February 27, 1998

KPMG Peat Marwick LLP

2001 M Street, N.W.
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

Director, U.S. Office of Personnel Management:

We have audited the accompanying 1997 financial statements of the Life Insurance Program (LP), administered by the U.S. Office of Personnel Management (OPM) Retirement and Insurance Service (RIS). In our opinion, based on our audit and the report of other auditors, the 1997 LP financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described in Note 1 to the financial statements.

In connection with our audit and in accordance with *Government Auditing Standards*, we also considered OPM's internal controls over financial reporting related to the LP and tested OPM's compliance with certain provisions of applicable laws and regulations related to the LP that could have a direct and material effect on its 1997 financial statements.

As a result of our consideration of internal control over financial reporting related to the LP, we identified the following reportable conditions:

1. Controls over contributions revenue;
2. Cash management - investments;
3. System Development Life Cycle (SDLC) for major systems implementation efforts;
4. Financial reporting, policies and procedures;
5. Reconciliation of inter-program transactions;
6. Controls over system software;
7. Comprehensive computer system and application risk assessments; and
8. Review procedures over carrier benefit payments.

We consider the first four reportable conditions to be material weaknesses.

As a result of our tests of compliance with certain provisions of applicable laws and regulations, we noted no instances of noncompliance that would be reportable under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*, as amended. In the compliance section below, we identify differences in material weaknesses identified by OPM in its Federal Managers' Financial Integrity Act (FMFIA) report, and those identified in our evaluation of LP's internal controls. In addition, the compliance section identifies noncompliance with Federal systems requirements, the U.S. Standard General Ledger, and Federal accounting requirements, described in the Federal Financial Management Improvement Act (FFMIA).

The results of our audit of the 1997 LP financial statements, our consideration of internal control over financial reporting, our tests of OPM's compliance with certain provisions of applicable laws and regulations related to the LP, and our responsibilities, are discussed in the remainder of this report.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying statement of financial position of the LP as of September 30, 1997, and the related statements of operations and changes in net position and cash flows for the year then ended. These financial statements are the responsibility of OPM's management. Our responsibility is to express an opinion on these financial statements based on our audit. We did not audit the financial statements of Metropolitan Life Insurance Company's Office of Federal Employees Group Life Insurance Programs (OFEGLI), which statements reflect assets constituting approximately 3% of total assets and approximately 99% of total benefit payments. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for OFEGLI, is based solely on the report of the other auditors.

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin 93-06, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance that 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 audit provides a reasonable basis for our opinion.

As described in Note 1, these financial statements were prepared in conformity with the hierarchy of accounting principles and standards recommended by the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, based on our audit and the report of the other auditors, the 1997 financial statements referred to above present fairly, in all material respects, the financial position of LP as of September 30, 1997, and the results of its operations and changes in net position and its cash flows for the year then ended, in conformity with the basis of accounting described in Note 1 to the financial statements.

Our audit was conducted for the purpose of forming an opinion on LP financial statements taken as a whole. The supplementary information captioned *Supplemental Schedule of Financial*

Position, Supplemental Schedule of Operations and Changes in Net Position and *Supplemental Schedule of Cash Flows* is presented for purposes of additional analysis and is not a required part of the principal financial statements. The 1997 supplementary information has been subjected to the procedures applied in the audit of the financial statements, and, in our opinion, based on our audit and, with respect to the amounts included for OFEGLI, the report of other auditors, is fairly stated in all material respects in relation to the principal financial statements taken as a whole.

The information in the Overview section entitled *The Life Insurance Program* contains a wide range of data, some of which is not directly related to the LP financial statements. The information in the Overview is not a required part of the principal financial statements but is supplementary information required by OMB Bulletin Nos. 94-01 and 97-01, *Form and Content of Agency Financial Statements*. We have considered whether this information is materially inconsistent with the principal financial statements. Such information has not been subjected to the procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

REPORT ON INTERNAL CONTROLS OVER FINANCIAL REPORTING

The management of OPM is responsible for establishing and maintaining internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that:

- transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements;

- funds, property, and other assets are safeguarded against loss from unauthorized use or disposition;

- transactions are executed in accordance with management's authorization and are properly recorded and accounted for to permit the preparation of reliable financial reports in conformity with applicable accounting principles described in Note 1 to the financial statements, and to maintain accountability over the assets; and

- data that supports reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Because of inherent limitations in internal controls, misstatements may nevertheless occur and not be detected. Also, projection of an evaluation of internal controls to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit, we considered OPM's internal control over financial reporting for LP in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements, and not to provide an opinion on the internal control over financial reporting. Accordingly, we do not express such an opinion. With respect to internal controls, we obtained an understanding of the design of relevant policies and procedures, determined if they had been placed in operation, assessed control risk, and performed tests of internal controls.

Our evaluation of the controls for performance information was limited to those controls designed to ensure the existence and completeness of the information. With respect to the performance measures control objectives, we obtained an understanding of relevant internal control policies and procedures designed to permit the preparation of reliable and complete performance information, and we assessed control risk.

Reportable conditions are matters coming to our attention that represent significant deficiencies in the design or operation of internal control that could adversely affect the LP's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A material weakness is a condition 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, or material to a performance measure or aggregate of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted certain matters involving internal controls over financial reporting and their operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and by OMB Bulletin 93-06, as amended.

Our consideration of internal control would not necessarily disclose all internal control matters that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. However, we noted the following weaknesses in internal control over financial reporting that we consider to be reportable conditions. We consider the first four reportable conditions to be material weaknesses.

1. Controls over Contributions Revenue

OPM has delegated responsibility to the employer agencies for (1) collection of contributions revenue from participants, (2) determination of an agency's contribution, (3) certification of employee eligibility for benefits, and (4) maintenance of supporting records. Establishing and maintaining adequate internal controls for transactions and testing the effectiveness of those internal controls are the employer agencies' responsibilities. OPM, as administrator, is dependent on the employer agencies for the accuracy and completeness of the data. OPM has prescribed minimum records, documentation and reconciliation requirements to the employer agencies, but does not monitor the effectiveness of employer agencies' controls or their degree of compliance with controls. As a result, OPM does not have a basis for relying on other agency internal controls as they relate to contributions recorded in its accounting records and other data received which support amounts recorded in the financial statements.

In addition, OPM does not have policies and procedures that provide for internal control and financial management over the contributions revenue collected from the employer agencies. Specifically, OPM has not implemented ongoing monitoring and review procedures to verify the accuracy and completeness of amounts received and recorded in its records, or implemented other compensating controls.

Recommendation

As noted in our prior year report, we continue to recommend that OPM establish an ongoing monitoring and review program over agency payroll office procedures and data reported and remitted to OPM, as a means of ensuring the accuracy and completeness of amounts recorded in its financial records.

2. Cash Management - Investments

OPM does not have adequate procedures for (1) authorizing and approving investment transactions, and (2) ensuring that the maximum and correct amounts available are invested timely. We noted a number of instances where Fund Balance with Treasury was over- or under-invested during fiscal year 1997. In one such instance, the under-invested balance was approximately $600 million. There were other instances where interest payments made by Treasury were not invested timely. In addition, OPM's investment ledger (intended to track transactions) was not complete, was not reviewed by a supervisor, and was not reconciled timely to balances in the general ledger.

Recommendation

OPM is installing a new core financial management system, which includes a separate investment module, and has obtained the services of a contractor to develop related policies and procedures. However, until implementation is complete, as noted in our prior year report, we continue to recommend OPM establish procedures that provide for (1) the preparation of cash management schedules that support the amount and timing of investment transactions, (2) documentation of reviews and authorizations of investment transactions, and (3) verification of the accuracy of schedules and balances, before amounts are invested.

3. System Development Life Cycle (SDLC) For Major Systems Implementation Efforts

OPM does not have a System Development Life Cycle (SDLC) for major systems implementation efforts. Without a SDLC, the development of systems is not coordinated with organizational strategic plans and goals and may result in acquisition of technology that does not provide the overall desired benefits for OPM at the organizational level.

Recommendation

As noted in our prior year report, we continue to recommend that OPM implement a SDLC which includes a needs analysis, systems design, and guidance for implementation, operations, and maintenance. This will provide OPM with a mechanism to help ensure that its business needs are addressed, costs are managed, deadlines are established, and management requirements for application controls are satisfied. We understand that OPM's plan requires involvement of users, including other agencies, and that it needs to be integrated across the agency as a whole.

4. Financial Reporting, Policies and Procedures

RIS' financial reporting responsibilities and policy-making should be enhanced to provide clearer integration of operational objectives with management and employee responsibilities. RIS' mission statement needs to thoroughly incorporate financial management objectives which are consistent with its fiduciary responsibilities as administrator of the LP. Furthermore, departmental and individual financial management responsibilities do not incorporate policies and procedures designed to monitor and ensure accuracy and completeness of financial reporting of the LP.

(a) Financial management plan

RIS is responsible for administering and managing the LP, including managing contributions received, determining and paying benefits, maintaining accurate benefit records, providing life insurance support services, and developing legislative initiatives for the LP. RIS has made progress in developing financial management policies to fulfill these responsibilities, but has not yet achieved full implementation. Accordingly, weaknesses in internal controls and accounting systems within OPM for the LP continue.

Recommendation

We recommend that RIS fully implement RP's financial management plan. The implementation of the plan will form an internal control structure for financial management and reporting.

(b) Financial management reengineering

OPM's processes and systems have evolved over a long period of time, and have changed to address specific issues or weaknesses in individual processes or systems, without necessarily assessing macro level effects. Therefore, OPM and the HBP operate in a paper and process intensive environment with numerous non-integrated information systems. Although QITs (quality improvement teams) were established by OPM to focus on financial system reengineering efforts, only limited progress has been made by the teams during fiscal year 1997.

Recommendations

- OPM's current Financial Management Status Report & Five-Year Plan includes plans to reengineer the retirement processing system based on identified requirements. The Business Reengineering Project also includes some requirements to be instituted for the LP. As noted in our prior year report, we recommend the LP Status Report and Five-Year Plan include a concerted effort to make fundamental changes to all processes affecting all disciplines and user groups. To be effective, this plan must address the effects of and interactions among human resources, technology and facilities. The focus of this effort should be directed at determining the minimum processes necessary to achieve the desired results, while maintaining an adequate system of controls.

- As we recommended last year, the cost of control processes should also be weighed against benefits achieved. We recommend RIS continue to develop action plans for reengineering and streamlining its financial operations and make changes to processes to eliminate redundancies, unnecessary approvals, and extraneous records.

- RIS should carry out its current plans to overhaul core program and financial systems so they will support the LP's mission of improving customer service and satisfaction. OPM should continue to improve its financial management systems by establishing fixed time frames and action plans. Once established, OPM should aggressively monitor the plans and time frames.

5. Reconciliation of Inter-Program Transactions

Life insurance premiums are withheld from annuitant payments in the Retirement Program (RP). The RP is responsible for transferring the amounts to the LP. However, the source information used to record the entry in the RP is not the same source information used to record the entry in the LP. OPM has not established adequate monthly reconciliation procedures to ensure all activity occurring between the programs is complete and accurate, and at year end, an out of balance condition existed between the programs.

Recommendation

As noted in our prior year report, we continue to recommend that OPM establish procedures to reconcile monthly activity between the RP and LP, and record entries in each program from the same source information.

6. Controls over System Software

The operating system's (IBM OS/390) primary integrity mechanism, Authorized Program Facility (APF), is not being properly controlled. Any program with APF authority has the ability to access all data files available to the OS/390 operating system and bypass IBM's access control software, Resource Access Control Facility (RACF). In addition, the system software administrative group, not the Security Administration, is currently the owner of the RACF data set. Consequently, there is a risk that unauthorized users can bypass RACF checking and perform sensitive security tasks, alter data integrity and/or control the operating system.

Recommendation

As noted in our prior year report, OPM management should develop APF administration policies and procedures to ensure compliance with IBM's integrity rules for all IBM operating systems. OPM should examine access privileges to APF libraries and determine if the current number of personnel with this level of access is necessary. In addition, the ownership and access rights to the RACF data set should be reevaluated.

7. Comprehensive Computer System and Application Risk Assessments

OPM has not conducted a comprehensive risk assessment of computer systems and applications. Risk assessments increase the likelihood that security policies and procedures are being made regarding which risks to accept and which to mitigate through security controls.

Recommendation

As noted in our prior year report, OPM should develop a process for ensuring that the assessment of risk is an on-going process, and that formal risk assessments are used in the development of security policies and procedures.

8. Review procedures over carrier benefit payments

Metropolitan Life Insurance Company (MetLife) administers the Federal Employees Group Life Insurance Program. MetLife does not maintain records of subscribers and their coverages. Claims are processed and paid by MetLife based on forms provided directly from participating federal agencies.

RIS has not implemented adequate claim review procedures which ensure payments made by MetLife to life insurance beneficiaries are accurate. RIS' Quality Assurance Division performs limited procedures to test claim payments; however, the following are not performed by OPM:

- Annual analytical reviews of total persons removed from the Central Personnel Data File (CPDF), Personnel Data File, and Annuity Roll Processing System, due to death, to total claims processed by MetLife;
- Review of escheat balances; and

- Maintenance of complete Form FE-6, *Claim for Death Benefits*, files to verify claims

<u>Recommendation</u>

As noted in our prior year report, we continue to recommend RIS establish its own procedures to verify the accuracy and validity of claims paid to beneficiaries of employees from other federal agencies. A regular review of MetLife escheatment procedures should also be performed on a regular basis. RIS should either assign these tasks to an internal quality assurance function or outsource them to ensure completion each year. We also recommend RIS consider implementing additional procedures, such as regularly reconciling plan members removed from the CPDF due to death to members receiving benefits.

* * * * *

These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the LP financial statements as of and for the year ended September 30, 1997.

We also noted other matters involving internal control over financial reporting and its operation that we do not consider to be reportable conditions that we have reported to the management of OPM in a separate letter dated February 27, 1998.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

The management of OPM is responsible for complying with laws and regulations applicable to the LP. As part of obtaining reasonable assurance about whether LP's financial statements are free of material misstatement, we performed tests of OPM's 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 other laws and regulations specified in OMB Bulletin No. 93-06, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit. Accordingly, we do not express such an opinion.

The results of our tests of compliance, performed as part of obtaining reasonable assurance about whether the LP financial statements are free of material misstatement, disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin 93-06, as amended.

Federal Managers' Financial Integrity Act (FMFIA) With respect to FMFIA compliance, OMB Bulletin 93-06, as amended, requires OPM's independent auditors to report if when there is a conflict between the agency's most recent FMFIA report and the auditors' evaluation of internal control over financial reporting based on their audit of the program's financial statements. Accordingly, as a part of our audit, we obtained an understanding of OPM's process for evaluating and reporting on internal control and accounting systems as required by the FMFIA and compared the OPM's 1997 FMFIA report results to the results of our evaluation of internal control.

In the internal control section of this report, we reported the System Development Life Cycle for major systems implementation efforts as a material internal control weakness which was not identified by OPM management as a weakness in the 1997 FMFIA report.

Federal Financial Management Improvement Act (FFMIA) OMB Bulletin 93-06, as amended, requires OPM's independent auditors to report whether OPM's financial management systems substantially comply with (1) Federal financial management system requirements, (2) applicable accounting standards, and (3) the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997.

The results of our tests disclosed instances, described below, where OPM's financial management systems did not substantially comply with the requirements discussed in the preceding paragraph:

- OPM has identified their core financial management system integration as a material non-conformance in its FMFIA report.

- RJS does not record transactions at the United States Government Standard General Ledger (SGL) level (i.e., subledgers do not process transactions consistent with SGL account description and posting requirements).

- OPM's financial management system does not support all program decision making. The system does not produce cost reports or other types of reports at meaningful levels.

OPM is in the process of implementing a new core financial management system, which is scheduled to be fully implemented by 1999, and anticipates the new system will resolve the above instances of FFMIA noncompliance.

An audit of financial statements conducted in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin 93-06, as amended, was not designed and does not provide any assurance that Year 2000 issues which may exist have been identified, on the adequacy of OPM's remediation plans related to Year 2000 financial or operational issues, or on whether OPM is or will become Year 2000 compliant. Further, we have no responsibility with regard to OPM's efforts to make its systems, or any other systems, such as those of OPM's vendors, service providers, or any other third parties Year 2000 compliant, or provide assurance on whether OPM has addressed or will be able to address all of the affected systems on a timely basis. These are responsibilities of OPM's management.

Recommendation

In addition to implementing the recommendations to improve internal controls, identified in the internal controls section of our report, we recommend OPM allocate the necessary budgetary and staffing resources to ensure timely implementation of the new core financial management system. (This action is in progress.) We also recommend OPM develop an effective self-assessment process to ensure compliance with all Federal financial management system requirements.

* * * * *

We also noted other matters involving compliance with laws and regulations that we do not consider to be material noncompliance related to LP that we have reported to the management of OPM in a separate letter dated February 27, 1998.

Distribution

This report is intended for the information of OPM's management, OPM's Office of the Inspector General, and the US Congress. However, this report is a matter of public record and its distribution is not limited.

KPMG Peat Marwick LLP

February 27, 1998

United States Office of Personnel Management

Accountability Report Fiscal Year 1998

OPM

UNITED STATES OFFICE OF PERSONNEL MANAGEMENT

KPMG LLP

INDEPENDENT AUDITORS' REPORT

Director, U.S. Office of Personnel Management:

We have audited the accompanying 1998 financial statements of the Retirement Program (RP), administered by the U.S. Office of Personnel Management (OPM) Retirement and Insurance Service (RIS). In connection with our audit and in accordance with *Government Auditing Standards*, we also considered OPM's internal controls over financial reporting related to the RP and tested OPM's compliance with certain provisions of applicable laws and regulations related to the RP that could have a direct and material effect on its 1998 financial statements.

In our opinion, RP's fiscal year 1998 financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described in Note 1 to the financial statements.

As a result of our consideration of internal control over financial reporting, we noted reportable conditions in the following areas:

1. Cash management – investments.
2. EDP general control environment.
3. Annual financial reporting, policies and procedures.
4. Controls over benefit payments made to annuitants.
5. Controls over annuity overpayments made to annuitants.

As a result of our tests of compliance with certain provisions of applicable laws and regulations, we noted no instances of reportable noncompliance with laws and regulations we tested that are required to be reported under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*, as amended.

Our conclusions and the scope of our work are discussed in more detail below.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying balance sheet of the RP as of September 30, 1998 and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended.

As described in Note 1, these financial statements were prepared in conformity with the hierarchy of accounting principles and standards recommended by the principals of the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

KPMG LLP

In our opinion, the 1998 financial statements referred to above present fairly, in all material respects, the financial position of the RP as of September 30, 1998, and its net cost, changes in net position, budgetary resources, and reconciliation of net cost to budgetary obligations for the year then ended, on the basis of accounting described in Note 1 to the financial statements.

As discussed in Note 1 to the financial statements, the RP implemented Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Concepts and Standards* and No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, effective October 1, 1997.

The information in the Overview section entitled *The Retirement Program* is not a required part of the financial statements but is other accompanying information required by OMB Bulletin 97-01, *Form and Content of Agency Financial Statements.* We have considered whether this information is materially inconsistent with the financial statements. However, we did not audit the Overview of the RP, and accordingly, we express no opinion on it. The performance information included in the Overview is addressed in the following section of our report, in accordance with OMB Bulletin No. 98-08, as amended.

INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted certain matters, described in items 1 through 5 below, involving the internal control over financial reporting and its operation that we consider to be reportable conditions under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 98-08, as amended. Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. Reportable conditions are matters coming to our attention that represent significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the RP's ability to record, process, summarize, and report financial data consistent with the assertions of 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. However, we do not consider the reportable conditions described below to be material weaknesses, as defined above. The status of prior year findings is presented in Exhibit I.

These conditions were considered in determining the nature, timing, and extent of audit procedures to be performed in our audit of the RP's 1998 financial statements. We also noted other matters involving internal control over financial reporting and its operation that we have reported to the management of OPM in a separate letter dated February 23, 1999.

1. Cash Management – Investments

OPM does not have adequate systems to effectively forecast and control investments. In addition, the investment subledgers are not always reconciled to the general ledger timely and do not provide evidence of supervisor review and approval.

Recommendation

As noted in our prior year's report, OPM is installing a new core financial management system which includes a separate investment module, and has obtained the services of a contractor to develop related policies and procedures. However, until implementation is complete, we continue to recommend OPM establish interim procedures that provide for (1) the preparation of cash management schedules that support the amount and timing of investment transactions, (2) documentation of reviews and authorizations of investment transactions, and (3) verification of the accuracy of schedules and balances before amounts are invested.

2. EDP General Control Environment

Our overall assessment of OPM's EDP control environment as a reportable condition relates to the following areas:

(a) Entity-Wide Security Program

Certain areas in OPM's entity-wide security program could be strengthened. An entity-wide security program, including security policies and a related implementation plan, is the foundation of an entity's security control structure and a reflection of senior management's commitment to addressing security risks. Without a well-designed program, security controls may be inadequate; responsibilities may be unclear, misunderstood, and improperly implemented; and controls may be inconsistently applied. Such conditions may lead to insufficient protection of sensitive or critical resources and disproportionately high expenditures for controls over low-risk resources.

Weaknesses identified include the following:

- RIS' mainframe security policies and procedures do not specifically address important aspects of security and RIS' local area network does not have formal documented security policies and procedures.
- Weaknesses exist in the security monitoring process.

(b) Access Control

OPM's EDP access controls require modification. Access controls should provide reasonable assurance that computer resources (data files, application programs, and computer-related facilities and equipment) are protected against unauthorized modification, disclosure, loss, or impairment. These controls include controls over physical access to computer resources, and controls that prevent unauthorized access to sensitive files.

Identified weaknesses include:

- Copies of data sets/tapes were created and shipped to third parties without appropriate documented desk procedures.
- Certain user accounts have excessive privileges to mainframe resources.

(c) Application Change Control/Systems Development

Certain controls over the modification of application software programs are deficient. Establishing controls over the modification of application software programs helps to ensure that only authorized programs and authorized modifications are implemented. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or "turned off" or that processing irregularities or malicious code could be introduced.

As noted in our prior year report, examples of weaknesses are as follows:

- A systems development methodology has not been developed for application software and the current "RSOD Retirement ADP Standards and Procedures" is missing critical chapters, including data set design and allocation, system development procedures, testing and acceptance, and system software installation and maintenance.
- A formal, comprehensive methodology for application change control has not been documented or implemented. For example, programs maintained by peripheral groups, like the Office of Actuaries, have little or no change controls.

(d) Service Continuity

Losing the capability to process, retrieve, and protect information maintained electronically can significantly impact OPM's ability to accomplish its mission. For this reason, an agency should have procedures in place to protect information resources and minimize the risk of unplanned interruptions and a plan to recover critical operations should interruptions occur. To mitigate service interruptions, it is essential that the related controls be understood and supported by management and staff throughout the organization.

Weaknesses in OPM's controls affecting service continuity include the following:

- RIS has not completed and tested a contingency plan for conducting operations should portions of their Year 2000 remediation efforts fail. A draft plan is currently under development.
- RIS' Local Area Network (LAN) room is not equipped with a smoke detector, dry sprinkler system or fire alarm, and deficiencies found during the computer room inspection by GSA are not consistently reported, tracked, and addressed in a timely manner.

Recommendation

We recommend that OPM develop a formal action plan to review and revise its EDP general controls. This plan should address each of the four areas discussed above as well as other areas that impact the general EDP control environment, set forth appropriate correction action steps, assign responsibilities to employees, and establish target completion dates for each action. This plan should be reviewed by the Office of the Inspector General and adopted by executive management of OPM and provide for periodic review of progress towards achievement of corrective actions.

3. Annual Financial Reporting, Policies and Procedures

Agencies' requirements to provide complex, audited financial information have increased and RIS' year-end financial reporting responsibilities have become more demanding. To respond to these demands, as soon as the fiscal year 1997 reporting requirements were met, RIS began analyzing the impact that OMB Bulletin No. 97-01 (Bulletin) would have on its 1998 financial reporting cycle. Out of their analysis, RIS produced policy statements that provided formal documentation on how the Bulletin would be implemented. For instance, the policy statements described how the benefit plans' general ledger accounts should combine to present the reporting format required by the Bulletin, how certain financial statement line items are be categorized under the Bulletin, and how the 1998 fiscal year financial statements should be displayed.

These proactive efforts enabled RIS to produce complete and accurate fiscal year 1998 financial statements in accordance with the Bulletin. However, the Bulletin's complex reporting and disclosure requirements and RIS' staffing limitations affected the adequacy of their quality control function for annual financial reporting. As a result, the following weaknesses were observed:

- Difficulty in producing complete and accurate year-end financial statement drafts in a timely manner;.
- Cross-reviews of financial statements and footnote drafts were not performed timely by the Benefits Accounting Branch and Financial Policy.

- Existing procedures did not require the Office of Actuaries to review the post-retirement benefit liabilities and disclosures presented in the financial statements.

- The Plans' draft financial statements and their related footnotes contained differing financial statement line item captions, account classifications or basis of presentation.

- Reconciliations were not performed to document the differences between budgetary amounts reported in the draft financial statements and corresponding amounts reported on the year end SF-133 and SF-2108 forms.

RIS segregated its reporting responsibilities between the Benefits Accounting Branch (BAB), who prepared the benefit plan financial statements and Financial Policy, who prepared the related footnotes, making regular communication and cross-reviews essential.

Recommendation

RIS should seek ways to strengthen the effectiveness of the financial reporting cycle controls to prevent financial reporting errors and inconsistencies and to improve the timeliness of year-end financial statement preparation. We recommend RIS institute a formal year-end financial statement preparation process, which requires BAB and Fiscal Policy to review and approve each other's financial statement drafts and footnotes. Additionally, once the Office of Actuaries (OA) has completed their work, RIS has posted the actuarial estimates and Financial Policy has prepared related footnote information, the OA should review and provide concurrence with the financial statement amounts and disclosures. The review and approval process should be documented to provide evidence of control.

RIS should also review the general ledger crosswalks and financial statement preparation procedures for all the plans to assure financial information will accumulate correctly in future years. To accomplish this, we recommend RIS review the difficulties they experienced in preparing the 1998 financial statements and determine what additional controls, policies or procedures are necessary to make fiscal year 1999's process more effective.

Prior to issuance of a new financial policy statement, we recommend RIS address the impact of that statement on the financial statement preparation process. BAB should actively meet with the Financial Policy group on major policy issues and establish a dialogue addressing what effects the new policy will have on their workload and systems capabilities. This action will allow BAB to better plan for the implementation of new financial accounting standards and policies before they must be put in place.

Also, management should realistically evaluate RIS' current staffing levels and processing methods to determine whether more resources or new procedures, or both, are needed to accomplish the objectives set forth in the preceding recommendations.

4. Controls Over Benefit Payments Made To Annuitants

Despite the current controls in place over benefit payments, errors continue to occur in benefit computations for payments made to annuitants. A statistically based projection was performed and we were able to determine from the results that the balances in the financial statements were materially correct. The Office of Retirement Programs (ORP) has not established consistent procedures and training across all departments to collect data related to process annuitant benefit applications and the occurrence of errors found during the adjudication process. In addition, detail data of the results from adjudication (e.g., errors found as part of review of benefit specialists work) performed throughout the year are not accumulated and reported to management for analysis on a periodic basis.

Recommendation

OPM should enhance controls over benefit payments made to annuitants to reduce the likelihood of errors in benefit calculations. OPM should evaluate the acceptability of error rates in benefit payment calculations and expand processing reviews to reduce the number of errors. The processor should review the accuracy of annuitant files from the inception of an annuitants' retirement, not just from the last adjudication or post-adjudication date.

We recommend OPM create data collection procedures to gather information on case adjudication, and determine causes for errors and whether procedural changes will eliminate these errors. We recommend OPM collect, at a minimum, the following data:

- number and description of errors found.
- cause of errors (e.g., keypunch, misinterpretation of legislation).
- timing of the errors (e.g., initial adjudication, post-adjudication).

Data analyses should include, but should not be limited to, the following:

- identification of time periods of large or unusual error occurrences.
- an indication of what stage of the process the errors occur (e.g., initial stage or during adjudication process).
- the types and frequencies of errors.
- a determination of the underlying cause of the errors.

Error information, including suggestions to avoid future errors, should continue to be communicated to the benefits processing specialist or reviewer who made the error. In addition, the results of the data analysis should be used to modify processing procedures and facilitate future training programs. These training programs should reinforce the importance of thorough and accurate reviews of retirement case files and benefit payment calculations prior to the payment of benefits, and should include procedures for informing reviewers of errors and necessary corrective actions. The content of the training courses should include a refresher course on the application of new laws and regulations affecting the adjudication process. The training program should also specify a minimum level of annual training for all benefit specialists and others involved in reviewing case files and should be consistent across all departments in the ORP.

5. Controls Over Annuity Overpayments Made to Annuitants

At September 30, 1998, the gross receivable for retirement benefit overpayments is over $115 million. The controls over calculating, recording, and collecting these amounts were deficient in the following areas:

- Reconciliations between subsididary ledgers and the general ledger were not consistent, timely or performed at all in certain areas.
- Interest and late charges on amounts due OPM were not computed in certain cases.
- Receivable balances were not adequately supported.

Where controls were determined to be deficient, we performed alternative procedures from which we concluded that the related financial statement balances were materially correct.

Recommendation

We recommend OPM record interest and applicable late charges, less an appropriate allowance for doubtful collection, on all outstanding receivables in accordance with the adopted or required policies and procedures of OPM. In addition, we recommend OPM generate reports or other documentation which identify individual receivable amounts, the length of time each is outstanding, the interest and applicable late charges calculated against each receivable, and the anticipated collection amount. In FY99, OPM implemented a new core financial system, which they anticipate will allow them to better manage their outstanding receivables. We recommend OPM ensure the receivable module is fully integrated in the new financial system and that the system provide information sufficient to properly report outstanding receivables and compute interest and applicable late charges for all receivables on a consistent basis.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests of compliance with the laws and regulations described above disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 98-08, as amended.

Under FFMIA, we are required to report whether RP's financial management systems substantially comply with (1) Federal financial management system requirements, (2) Federal accounting standards, and (3) the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin No. 98-08, as amended.

The results of our tests disclosed instances, described below, where RP's financial management systems did not substantially comply with the requirements discussed in the preceding paragraph:

- OPM has identified their core financial management system as a material nonconformance in its FMFIA report because the system does not meet OMB Circular A-127 requirements for automated systems integration and transaction-driven general ledger system capabilities.

- RIS does not record transactions at the United States Government Standard General Ledger (SGL) level (i.e., sub-ledgers do not process transactions consistent with SGL account description and posting requirements).

- OPM's financial management system does not support all program decision-making.

RIS has implemented a new core financial management system to process financial transactions beginning October 1, 1998. OPM anticipates the new system will resolve the above financial management system compliance matters.

RESPONSIBILITIES

Management's Responsibility. Management is responsible for:

- Preparing the financial statements in conformity with the comprehensive basis of accounting described in Note 1 to the financial statements.

- Establishing and maintaining internal control over financial reporting.

- Complying with applicable laws and regulations.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control of financial reporting are to provide management with reasonable, but not absolute, assurance that:

- transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements, and certain other laws, regulations, and government-wide policies identified by the OMB as applicable to the RP;

- assets are safeguarded against loss from unauthorized acquisition, use or disposition;

- transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with applicable accounting principles described in Note 1 to the financial statements; and

- transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.

Auditors' Responsibility. Our responsibility is to express an opinion on the RP financial statements as of and for the year ended September 30, 1998 based on our audit. We are also responsible for considering OPM's internal control over financial reporting related to the RP and testing OPM's compliance with certain provisions of applicable laws and regulations related to the RP that could have a direct and material effect on its 1998 financial statements.

To fulfill these responsibilities, we performed procedures such as the following:

- Examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

- Assessed the accounting principles used and significant estimates made by management.

- Evaluated the overall financial statement presentation.

In planning and performing our audit, we considered OPM's internal control over financial reporting by obtaining an understanding of the agency's significant internal controls, determined whether these internal controls have 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, and not to provide assurance on the internal control over financial reporting. Consequently, we do not provide an opinion on internal controls.

In addition, with respect to internal controls related to performance measures determined by management to be key and reported in the Overview to the financial statements, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 98-08, as amended. 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.

Because of inherent limitations in internal control, fraud may nevertheless occur and not be detected. Also, projection of an evaluation of internal control over financial reporting to future periods is subject to the risk that internal control procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

As part of obtaining reasonable assurance about whether RP's financial statements are free of material misstatement, we performed tests of RP's 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 other laws and regulations specified in OMB Bulletin No. 98-08, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit. Accordingly, we do not express such an opinion.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards*, issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin No. 98-08, as amended. The 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 audit provides a reasonable basis for our opinion.

Distribution

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

KPMG LLP

February 23, 1999
Washington, D.C.

INDEPENDENT AUDITORS' REPORT

Director, U.S. Office of Personnel Management:

We have audited the accompanying 1998 financial statements of the Health Benefits Insurance Program (HBP), administered by the U.S. Office of Personnel Management (OPM) Retirement and Insurance Service (RIS). In connection with our audit and in accordance with *Government Auditing Standards*, we also considered OPM's internal controls over financial reporting related to the HBP and tested OPM's compliance with certain provisions of applicable laws and regulations related to the HBP that could have a direct and material effect on its 1998 financial statements.

In our opinion, based on our audit and the report of the other auditors, HBP's fiscal year 1998 financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described in Note 1 to the financial statements.

As a result of our consideration of internal control over financial reporting, we noted reportable conditions in the following areas. We consider the last condition, *financial reporting control environment*, to be a material weakness.

1. Cash management – investments.
2. EDP general control environment.
3. Annual financial reporting, policies and procedures.
4. Reconciliation of inter-program transactions.
5. Controls over program administration by the health carriers.
6. Financial reporting control environment.

As a result of our tests of compliance with certain provisions of applicable laws and regulations, we noted no instances of reportable noncompliance with laws and regulations we tested that are required to be reported under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*, as amended.

Our conclusions and the scope of our work are discussed in more detail below.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying balance sheet of the HBP as of September 30, 1998 and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended. We did not audit the financial statements of the experience-rated health carriers, which statements reflect assets constituting approximately 1% of total assets and substantially all of the total benefits expense. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for or provided by the experience-rated carriers, is based solely on the reports of the other auditors.

As described in Note 1, these financial statements were prepared in conformity with the hierarchy of accounting principles and standards recommended by the principals of the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, based on our audit and the report of the other auditors, the 1998 financial statements referred to above present fairly, in all material respects, the financial position of the HBP as of September 30, 1998, and its net cost, changes in net position, budgetary resources, and reconciliation of net cost to budgetary obligations for the year then ended, on the basis of accounting described in Note 1 to the financial statements.

As discussed in Note 1 to the financial statements, the HBP implemented Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Concepts and Standards* and No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, and Financial Accounting Standards Board Statement No. 132, *Employers' Disclosures about Pension and Other Postretirement Benefits*, effective October 1, 1997.

The information in the Overview section entitled *The Health Benefits Insurance Program* is not a required part of the financial statements but is other accompanying information required by OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*. We have considered whether this information is materially inconsistent with the financial statements. However, we did not audit the Overview of the HBP, and accordingly, we express no opinion on it. The performance information included in the Overview is addressed in the following section of our report, in accordance with OMB Bulletin No. 98-08, as amended.

INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted certain matters, described in items 1 through 6 below, involving the internal control over financial reporting and its operation that we consider to be reportable conditions under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 98-08, as amended. Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. Reportable conditions are matters coming to our attention that represent significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the HBP's ability to record, process, summarize, and report financial data consistent with the assertions of 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. We consider the last reportable condition described below, *financial reporting control environment*, to be a material weakness. The status of prior year findings is presented in Exhibit I.

These conditions were considered in determining the nature, timing, and extent of audit procedures to be performed in our audit of the HBP's 1998 financial statements. We also noted other matters involving internal control over financial reporting and its operation that we have reported to the management of OPM in a separate letter dated February 23, 1999.

1. Cash Management – Investments

OPM does not have adequate systems to effectively forecast and control investments. In addition, the investment subledgers are not always reconciled to the general ledger timely and do not provide evidence of supervisor review and approval.

<u>**Recommendation**</u>

As noted in our prior year's report, OPM is installing a new core financial management system which includes a separate investment module, and has obtained the services of a contractor to develop related policies and procedures. However, until implementation is complete, we continue to recommend OPM establish interim procedures that provide for (1) the preparation of cash management schedules that support the amount and timing of investment transactions, (2) documentation of reviews and authorizations of investment transactions, and (3) verification of the accuracy of schedules and balances before amounts are invested.

2. EDP General Control Environment

Our overall assessment of OPM's EDP control environment as a reportable condition relates to the following areas:

(a) Entity-Wide Security Program

Certain areas in OPM's entity-wide security program could be strengthened. An entity-wide security program, including security policies and a related implementation plan, is the foundation of an entity's security control structure and a reflection of senior management's commitment to addressing security risks. Without a well-designed program, security controls may be inadequate; responsibilities may be unclear, misunderstood, and improperly implemented; and controls may be inconsistently applied. Such conditions may lead to insufficient protection of sensitive or critical resources and disproportionately high expenditures for controls over low-risk resources.

Weaknesses identified include the following:

- RIS' mainframe security policies and procedures do not specifically address important aspects of security and RIS' local area network does not have formal documented security policies and procedures.
- Weaknesses exist in the security monitoring process.

(b) Access Control

OPM's EDP access controls require modification. Access controls should provide reasonable assurance that computer resources (data files, application programs, and computer-related facilities and equipment) are protected against unauthorized modification, disclosure, loss, or impairment. These controls include controls over physical access to computer resources, and controls that prevent unauthorized access to sensitive files.

Identified weaknesses include:

- Copies of data sets/tapes were created and shipped to third parties without appropriate documented desk procedures.
- Certain user accounts have excessive privileges to mainframe resources.

(c) Application Change Control/Systems Development

Certain controls over the modification of application software programs are deficient. Establishing controls over the modification of application software programs helps to ensure that only authorized programs and authorized modifications are implemented. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or "turned off" or that processing irregularities or malicious code could be introduced.

As noted in our prior year report, examples of weaknesses are as follows:

- A systems development methodology has not been developed for application software and the current "RSOD Retirement ADP Standards and Procedures" is missing critical chapters, including data set design and allocation, system development procedures, testing and acceptance, and system software installation and maintenance.
- A formal, comprehensive methodology for application change control has not been documented or implemented. For example, programs maintained by peripheral groups, like the Office of Actuaries, have little or no change controls.

(d) Service Continuity

Losing the capability to process, retrieve, and protect information maintained electronically can significantly impact OPM's ability to accomplish its mission. For this reason, an agency should have procedures in place to protect information resources and minimize the risk of unplanned interruptions and a plan to recover critical operations should interruptions occur. To mitigate service interruptions, it is essential that the related controls be understood and supported by management and staff throughout the organization.

Weaknesses in OPM's controls affecting service continuity include the following:

- RIS has not completed and tested a contingency plan for conducting operations should portions of their Year 2000 remediation efforts fail. A draft plan is currently under development.
- RIS' Local Area Network (LAN) room is not equipped with a smoke detector, dry sprinkler system or fire alarm, and deficiencies found during the computer room inspection by GSA are not consistently reported, tracked, and addressed in a timely manner.

Recommendation

We recommend that OPM develop a formal action plan to review and revise its EDP general controls. This plan should address each of the four areas discussed above as well as other areas that impact the general EDP control environment, set forth appropriate correction action steps, assign responsibilities to employees, and establish target completion dates for each action. This plan should be reviewed by the Office of the Inspector General and adopted by executive management of OPM and provide for periodic review of progress towards achievement of corrective actions.

3. Annual Financial Reporting, Policies and Procedures

Agencies' requirements to provide complex, audited financial information have increased and RIS' year-end financial reporting responsibilities have become more demanding. To respond to these demands, as soon as the fiscal year 1997 reporting requirements were met, RIS began analyzing the impact that OMB Bulletin No. 97-01 (Bulletin) would have on its 1998 financial reporting cycle. Out of their analysis, RIS produced policy statements that provided formal documentation on how the Bulletin would be implemented. For instance, the policy statements described how the benefit plans' general ledger accounts should combine to present the reporting format required by the Bulletin, how certain financial statement line items are be categorized under the Bulletin, and how the 1998 fiscal year financial statements should be displayed.

These proactive efforts enabled RIS to produce complete and accurate fiscal year 1998 financial statements in accordance with the Bulletin. However, the Bulletin's complex reporting and disclosure requirements and RIS' staffing limitations affected the adequacy of their quality control function for annual financial reporting. As a result, the following weaknesses were observed:

- Difficulty in producing complete and accurate year-end financial statement drafts in a timely manner;

- Cross-reviews of financial statements and footnote drafts were not performed timely by the Benefits Accounting Branch and Financial Policy.

- Existing procedures did not require the Office of Actuaries to review the post-retirement benefit liabilities and disclosures presented in the financial statements.

- The Plans' draft financial statements and their related footnotes contained differing financial statement line item captions, account classifications or basis of presentation.

- Reconciliations were not performed to document the differences between budgetary amounts reported in the draft financial statements and corresponding amounts reported on the year end SF-133 and SF-2108 forms.

RIS segregated its reporting responsibilities between the Benefits Accounting Branch (BAB), who prepared the benefit plan financial statements and Financial Policy, who prepared the related footnotes, making regular communication and cross-reviews essential.

<u>Recommendation</u>

RIS should seek ways to strengthen the effectiveness of the financial reporting cycle controls to prevent financial reporting errors and inconsistencies and to improve the timeliness of year-end financial statement preparation. We recommend RIS institute a formal year-end financial statement preparation process, which requires BAB and Fiscal Policy to review and approve each other's financial statement drafts and footnotes. Additionally, once the Office of Actuaries (OA) has completed their work, RIS has posted the actuarial estimates and Financial Policy has prepared related footnote information, the OA should review and provide concurrence with the financial statement amounts and disclosures. The review and approval process should be documented to provide evidence of control.

RIS should also review the general ledger crosswalks and financial statement preparation procedures for all the plans to assure financial information will accumulate correctly in future years. To accomplish this, we recommend RIS review the difficulties they experienced in preparing the 1998 financial statements and determine what additional controls, policies or procedures are necessary to make fiscal year 1999's process more effective.

Prior to issuance of a new financial policy statement, we recommend RIS address the impact of that statement on the financial statement preparation process. BAB should actively meet with the Financial Policy group on major policy issues and establish a dialogue addressing what effects the new policy will have on their workload and systems capabilities. This action will allow BAB to better plan for the implementation of new financial accounting standards and policies before they must be put in place.

Also, management should realistically evaluate RIS' current staffing levels and processing methods to determine whether more resources or new procedures, or both, are needed to accomplish the objectives set forth in the preceding recommendations.

4. Reconciliation of Inter-Program Transactions

Health insurance premiums are withheld from annuitant payments in the Retirement Program (RP). The RP is responsible for transferring the amounts to the HBP. However, the source information used to record the entry in the RP is not the same source information used to record the entry in the HBP. Although OPM has issued policy guidance as to how these transactions should be recorded in the future, OPM has not identified the origin of the problem and has not corrected existing balance differences.

<u>Recommendation</u>

As noted in our prior fiscal years' 1996 and 1997 reports, we continue to recommend that OPM (1) determine what is causing the inter-program differences, (2) reconcile the existing differences between the RP and HBP, and (3) assure procedures are in place that will prevent future out-of-balance situations.

5. Controls Over Program Administration By The Health Carriers

RIS contracts with community-rated and experience-rated health carriers to provide claims processing functions for the HBP. These carriers administer the Program's claims activity, which constititutes a substantial amount of the HBP's net costs. Because this activity occurs outside of OPM's control environment and the activity is significant to the HBP, RIS should assure that its monitoring of the carriers is adequate. Areas where improvements should be made are described below.

(a) Premiums expense controls – community-rated carriers

OPM remits premiums it receives from federal Agencies to Community-Rated Carriers (CRCs) twice a month. OPM's existing systems were not designed to centrally associate the monies paid as premiums to participating carriers with the enrollees for which they are being paid. Consequently, the potential exists for carriers to provide benefits to employees who are not covered by their plan at the time the services are rendered. To reinforce the need for effective enrollment reconciliations, OPM issued a payroll letter requiring agency payroll offices to provide carriers with the names of enrollees and the amounts withheld from pay for health benefits, by carrier, on a quarterly basis. However, OPM does not have a regular monitoring program to determine whether payroll offices are complying with these requirements and whether carriers are reconciling their enrollment records regularly.

Recommendation

OPM plans to implement a centralized enrollment system to resolve this internal control weakness. However, until the system can be developed, we recommend OPM establish more regular reviews of community rated carrier enrollment reconciliations.

(b) Monitoring of internal control and contract compliance – experience-rated carriers

Beginning with fiscal year 1998, experience-rated health carriers were required to comply with the OPM Experience Rated Carrier (ERC) Audit Guide (Guide). The Guide requires ERCs to submit annual audit and attestation reports to OPM relating to FEHB financial activity, internal controls and contract compliance. These reports provide the basis for a material portion of the HBP financial activity and also provide evidence of the condition of the related internal controls maintained by the carriers.

RIS documented their conclusions about the results of reports submitted by the experience rated carriers and developed a monitoring plan for fiscal years 1999 and thereafter. However, the results upon which RIS based their conclusions for fiscal year 1998 should be further documented and the plan further developed. For instance, several carriers reported findings and several others did not comply with the Guide in a timely manner. Each instance has some cumulative effect on the overall conclusion RIS made about the overall integrity of carrier data and the overall control environment that resides at the carriers. The consideration of these separate effects and how they were accumulated to arrive at the overall conclusion should be documented by RIS.

In addition, the ERC monitoring plan developed by RIS should be specific enough to implement quickly, since there is a relatively short time period between evaluation of the prior year's findings and the end of the next fiscal year. For instance, the plan should target those specific findings that were found to be common to many carriers (such as cash management), and those specific carriers who had findings of concern to RIS. Also, the monitoring plan does not specify when the actions listed should be performed or by whom.

Recommendation

We recommend RIS establish more detailed procedures and documentation for (1) reviewing anc evaluating the results of reports submitted by carriers who must comply annually with the Guide and (2) developing a monitoring plan that targets those areas of concern resulting from the review and evaluation process.

6. Financial Reporting Control Environment

The Health Benefits Program general ledger system does not support the fiscal year 1998 financial statements. As a result, RIS cannot prepare financial statements without the use of subsidiary or manual ledgers that do not always agree to the corresponding general ledger accounts. RIS uses four different trial balances to compile financial information. These trial balances have different classifications and sets of accounts for common data elements and are not integrated with other subsidiary information systems capturing financial data, causing discrepancies between the general ledger accounts and the documentation supporting their activity. Accordingly, preparation of the 1998 financial statements required more time to reconcile these various data sources.

In addition, RIS has not established an efficient transaction entry system to account for ERC activity. RIS uses two cost centers to record ERC activity, from which duplicate activity must be eliminated for financial reporting purposes. However, standard elimination entries have not been developed to prevent recording duplicate financial transactions relating to the same activity.

Recommendation

We recommend RIS:

- Establish common data elements and standard data classifications for recording financial events related to ERC activity.
- Establish a common transaction processing system to enable the ERC transactions to be reported in a consistent manner.
- Establish internal control policies and procedures over data entry, transaction processing, and reporting to ensure the validity of information related to ERC activity.
- Establish an efficient transaction entry system to eliminate unnecessary duplication of financial information in the general ledger.
- Eliminate the use of multiple trial balances to account for HBP activity.

RIS will continue to experience difficulty in preparing accurate and timely financial statements for the HBP unless the current general ledger system is redesigned and appropriate new procedures for analyzing, processing and recording data are developed.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests of compliance with the laws and regulations described above disclosed ı instances of noncompliance that are required to be reported herein under *Government Auditi Standards* or OMB Bulletin No. 98-08, as amended.

Under FFMIA, we are required to report whether HBP's financial management syster substantially comply with (1) Federal financial management system requirements, (2) Feder accounting standards, and (3) the United States Standard General Ledger at the transaction lev To meet this requirement, we performed tests of compliance using the implementation guidan for FFMIA included in Appendix D of OMB Bulletin No. 98-08, as amended.

The results of our tests disclosed instances, described below, where HBP's financial manageme systems did not substantially comply with the requirements discussed in the precedir paragraph:

- OPM has identified their core financial management system as a material nonconformance : its FMFIA report because the system does not meet OMB Circular A-127 requirements f automated systems integration and transaction-driven general ledger system capabilities.
- RIS does not record transactions at the United States Government Standard General Ledg (SGL) level (i.e., sub-ledgers do not process transactions consistent with SGL accou description and posting requirements).
- OPM's financial management system does not support all program decision-making.

RIS has implemented a new core financial management system to process financial transactior beginning October 1, 1998. OPM anticipates the new system will resolve the above financi management system compliance matters.

RESPONSIBILITIES

Management's Responsibility. Management is responsible for:

- Preparing the financial statements in conformity with the comprehensive basis of accountin described in Note 1 to the financial statements.
- Establishing and maintaining internal control over financial reporting.
- Complying with applicable laws and regulations.

In fulfilling this responsibility, estimates and judgments by management are required to asses the expected benefits and related costs of internal control policies and procedures. Th objectives of internal control of financial reporting are to provide management with reasonable, but not absolute, assurance that:

- transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements, and certain other laws, regulations, and government-wide policies identified by the OMB as applicable to the HBP;
- assets are safeguarded against loss from unauthorized acquisition, use or disposition;
- transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with applicable accounting principles described in Note 1 to the financial statements; and
- transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.

Auditors' Responsibility. Our responsibility is to express an opinion on the HBP financial statements as of and for the year ended September 30, 1998 based on our audit. We are also responsible for considering OPM's internal control over financial reporting related to the HBP and testing OPM's compliance with certain provisions of applicable laws and regulations related to the HBP that could have a direct and material effect on its 1998 financial statements.

To fulfill these responsibilities, we performed procedures such as the following:

- Examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
- Assessed the accounting principles used and significant estimates made by management.
- Evaluated the overall financial statement presentation.

In planning and performing our audit, we considered OPM's internal control over financial reporting by obtaining an understanding of the agency's significant internal controls, determined whether these internal controls have 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, and not to provide assurance on the internal control over financial reporting. Consequently, we do not provide an opinion on internal controls.

In addition, with respect to internal controls related to performance measures determined by management to be key and reported in the Overview to the financial statements, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 98-08, as amended. 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.

Because of inherent limitations in internal control, fraud may nevertheless occur and not be detected. Also, projection of an evaluation of internal control over financial reporting to future periods is subject to the risk that internal control procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

As part of obtaining reasonable assurance about whether HBP's financial statements are free of material misstatement, we performed tests of HBP's 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 other laws and regulations specified in OMB Bulletin No. 98-08, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit. Accordingly, we do not express such an opinion.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards*, issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin No. 98-08, as amended. The 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 audit provides a reasonable basis for our opinion.

Distribution

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

KPMG LLP

February 23, 1999
Washington, D.C.

KPMG LLP

INDEPENDENT AUDITORS' REPORT

Director, U.S. Office of Personnel Management:

We have audited the accompanying 1998 financial statements of the Life Insurance Program (LP), administered by the U.S. Office of Personnel Management (OPM) Retirement and Insurance Service (RIS). In connection with our audit and in accordance with *Government Auditing Standards*, we also considered OPM's internal controls over financial reporting related to the LP and tested OPM's compliance with certain provisions of applicable laws and regulations related to the LP that could have a direct and material effect on its 1998 financial statements.

In our opinion, based on our audit and the report of the other auditors, LP's fiscal year 1998 financial statements are presented fairly, in all material respects, in conformity with the basis of accounting described in Note 1 to the financial statements.

As a result of our consideration of internal control over financial reporting, we noted reportable conditions in the following areas:

1. Cash management – investments.
2. EDP general control environment.
3. Annual financial reporting, policies and procedures.
4. Reconciliation of inter-program transactions.

As a result of our tests of compliance with certain provisions of applicable laws and regulations, we noted no instances of reportable noncompliance with laws and regulations we tested that are required to be reported under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*, as amended.

Our conclusions and the scope of our work are discussed in more detail below.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying balance sheet of the LP as of September 30, 1998 and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended. We did not audit the financial statements of Metropolitan Life Insurance Company's Office of Federal Employees Group Life Insurance Programs (OFEGLI), which statements reflect assets constituting approximately 2% of the total assets and substantially all of the total benefit payments. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for OFEGLI, is based solely on the report of other auditors.

As described in Note 1, these financial statements were prepared in conformity with the hierarchy of accounting principles and standards recommended by the principals of the Federal Accounting Standards Advisory Board. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, based on our audit and the report of the other auditors, the 1998 financial statements referred to above present fairly, in all material respects, the financial position of the LP as of September 30, 1998, and its net cost, changes in net position, budgetary resources, and reconciliation of net cost to budgetary obligations for the year then ended, on the basis of accounting described in Note 1 to the financial statements.

As discussed in Note 1 to the financial statements, the LP implemented Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Concepts and Standards* and No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, effective October 1, 1997.

The information in the Overview section entitled *The Life Insurance Program* is not a required part of the financial statements but is other accompanying information required by OMB Bulletin 97-01, *Form and Content of Agency Financial Statements*. We have considered whether this information is materially inconsistent with the financial statements. However, we did not audit the Overview of the LP, and accordingly, we express no opinion on it. The performance information included in the Overview is addressed in the following section of our report, in accordance with OMB Bulletin No. 98-08, as amended.

INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted certain matters, described in items 1 through 4 below, involving the internal control over financial reporting and its operation that we consider to be reportable conditions under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 98-08, as amended. Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses. Reportable conditions are matters coming to our attention that represent significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the LP's ability to record, process, summarize, and report financial data consistent with the assertions of 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. However, we do not consider the reportable conditions described below to be material weaknesses, as defined above. The status of prior year findings is presented in Exhibit I.

These conditions were considered in determining the nature, timing, and extent of audit procedures to be performed in our audit of the LP's 1998 financial statements. We also noted other matters involving internal control over financial reporting and its operation that we have reported to the management of OPM in a separate letter dated February 23, 1999.

1. Cash Management – Investments

OPM does not have adequate systems to effectively forecast and control investments. In addition, the investment subledgers are not always reconciled to the general ledger timely and do not provide evidence of supervisor review and approval.

Recommendation

As noted in our prior year's report, OPM is installing a new core financial management system which includes a separate investment module, and has obtained the services of a contractor to develop related policies and procedures. However, until implementation is complete, we continue to recommend OPM establish interim procedures that provide for (1) the preparation of cash management schedules that support the amount and timing of investment transactions, (2) documentation of reviews and authorizations of investment transactions, and (3) verification of the accuracy of schedules and balances before amounts are invested.

2. EDP General Control Environment

Our overall assessment of OPM's EDP control environment as a reportable condition relates to the following areas:

(a) Entity-Wide Security Program

Certain areas in OPM's entity-wide security program could be strengthened. An entity-wide security program, including security policies and a related implementation plan, is the foundation of an entity's security control structure and a reflection of senior management's commitment to addressing security risks. Without a well-designed program, security controls may be inadequate; responsibilities may be unclear, misunderstood, and improperly implemented; and controls may be inconsistently applied. Such conditions may lead to insufficient protection of sensitive or critical resources and disproportionately high expenditures for controls over low-risk resources.

Weaknesses identified include the following:

- RIS' mainframe security policies and procedures do not specifically address important aspects of security and RIS' local area network does not have formal documented security policies and procedures.
- Weaknesses exist in the security monitoring process.

(b) Access Control

OPM's EDP access controls require modification. Access controls should provide reasonable assurance that computer resources (data files, application programs, and computer-related facilities and equipment) are protected against unauthorized modification, disclosure, loss, or impairment. These controls include controls over physical access to computer resources, and controls that prevent unauthorized access to sensitive files.

Identified weaknesses include:

- Copies of data sets/tapes were created and shipped to third parties without appropriate documented desk procedures.
- Certain user accounts have excessive privileges to mainframe resources.

(c) Application Change Control/Systems Development

Certain controls over the modification of application software programs are deficient. Establishing controls over the modification of application software programs helps to ensure that only authorized programs and authorized modifications are implemented. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or "turned off" or that processing irregularities or malicious code could be introduced.

As noted in our prior year report, examples of weaknesses are as follows:

- A systems development methodology has not been developed for application software and the current "RSOD Retirement ADP Standards and Procedures" is missing critical chapters, including data set design and allocation, system development procedures, testing and acceptance, and system software installation and maintenance.
- A formal, comprehensive methodology for application change control has not been documented or implemented. For example, programs maintained by peripheral groups, like the Office of Actuaries, have little or no change controls.

(d) Service Continuity

Losing the capability to process, retrieve, and protect information maintained electronically can significantly impact OPM's ability to accomplish its mission. For this reason, an agency should have procedures in place to protect information resources and minimize the risk of unplanned interruptions and a plan to recover critical operations should interruptions occur. To mitigate service interruptions, it is essential that the related controls be understood and supported by management and staff throughout the organization.

Weaknesses in OPM's controls affecting service continuity include the following:

- RIS has not completed and tested a contingency plan for conducting operations should portions of their Year 2000 remediation efforts fail. A draft plan is currently under development.
- RIS' Local Area Network (LAN) room is not equipped with a smoke detector, dry sprinkler system or fire alarm, and deficiencies found during the computer room inspection by GSA are not consistently reported, tracked, and addressed in a timely manner.

<u>Recommendation</u>

We recommend that OPM develop a formal action plan to review and revise its EDP general controls. This plan should address each of the four areas discussed above as well as other areas that impact the general EDP control environment, set forth appropriate correction action steps, assign responsibilities to employees, and establish target completion dates for each action. This plan should be reviewed by the Office of the Inspector General and adopted by executive management of OPM and provide for periodic review of progress towards achievement of corrective actions.

3. Annual Financial Reporting, Policies and Procedures

Agencies' requirements to provide complex, audited financial information have increased and RIS' year-end financial reporting responsibilities have become more demanding. To respond to these demands, as soon as the fiscal year 1997 reporting requirements were met, RIS began analyzing the impact that OMB Bulletin No. 97-01 (Bulletin) would have on its 1998 financial reporting cycle. Out of their analysis, RIS produced policy statements that provided formal documentation on how the Bulletin would be implemented. For instance, the policy statements described how the benefit plans' general ledger accounts should combine to present the reporting format required by the Bulletin, how certain financial statement line items are be categorized under the Bulletin, and how the 1998 fiscal year financial statements should be displayed.

These proactive efforts enabled RIS to produce complete and accurate fiscal year 1998 financial statements in accordance with the Bulletin. However, the Bulletin's complex reporting and disclosure requirements and RIS' staffing limitations affected the adequacy of their quality control function for annual financial reporting. As a result, the following weaknesses were observed:

- Difficulty in producing complete and accurate year-end financial statement drafts in a timely manner;

- Cross-reviews of financial statements and footnote drafts were not performed timely by the Benefits Accounting Branch and Financial Policy.

- Existing procedures did not require the Office of Actuaries to review the post-retirement benefit liabilities and disclosures presented in the financial statements.

- The Plans' draft financial statements and their related footnotes contained differing financial statement line item captions, account classifications or basis of presentation.

- Reconciliations were not performed to document the differences between budgetary amounts reported in the draft financial statements and corresponding amounts reported on the year end SF-133 and SF-2108 forms.

RIS segregated its reporting responsibilities between the Benefits Accounting Branch (BAB), who prepared the benefit plan financial statements and Financial Policy, who prepared the related footnotes, making regular communication and cross-reviews essential.

Recommendation

RIS should seek ways to strengthen the effectiveness of the financial reporting cycle controls to prevent financial reporting errors and inconsistencies and to improve the timeliness of year-end financial statement preparation. We recommend RIS institute a formal year-end financial statement preparation process, which requires BAB and Fiscal Policy to review and approve each other's financial statement drafts and footnotes. Additionally, once the Office of Actuaries (OA) has completed their work, RIS has posted the actuarial estimates and Financial Policy has prepared related footnote information, the OA should review and provide concurrence with the financial statement amounts and disclosures. The review and approval process should be documented to provide evidence of control.

RIS should also review the general ledger crosswalks and financial statement preparation procedures for all the plans to assure financial information will accumulate correctly in future years. To accomplish this, we recommend RIS review the difficulties they experienced in preparing the 1998 financial statements and determine what additional controls, policies or procedures are necessary to make fiscal year 1999's process more effective.

Prior to issuance of a new financial policy statement, we recommend RIS address the impact of that statement on the financial statement preparation process. BAB should actively meet with the Financial Policy group on major policy issues and establish a dialogue addressing what effects the new policy will have on their workload and systems capabilities. This action will allow BAB to better plan for the implementation of new financial accounting standards and policies before they must be put in place.

Also, management should realistically evaluate RIS' current staffing levels and processing methods to determine whether more resources or new procedures, or both, are needed to accomplish the objectives set forth in the preceding recommendations.

4. Reconciliation of Inter-Program Transactions

Life insurance premiums are withheld from annuitant payments in the Retirement Program (RP). The RP is responsible for transferring the amounts to the LP. However, the source information used to record the entry in the RP is not the same source information used to record the entry in the LP. Although OPM has issued policy guidance as to how these transactions should be recorded in the future, OPM has not identified the origin of the problem and has not corrected existing balance differences.

Recommendation

As noted in our prior fiscal years' 1996 and 1997 reports, we continue to recommend that OPM (1) determine what is causing the inter-program differences, (2) reconcile the existing differences between the RP and LP, and (3) assure procedures are in place that will prevent future out-of-balance situations.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests of compliance with the laws and regulations described above disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 98-08, as amended.

Under FFMIA, we are required to report whether RP's financial management systems substantially comply with (1) Federal financial management system requirements, (2) Federal accounting standards, and (3) the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin No. 98-08, as amended.

The results of our tests disclosed instances, described below, where LP's financial management systems did not substantially comply with the requirements discussed in the preceding paragraph:

- OPM has identified their core financial management system as a material nonconformance in its FMFIA report because the system does not meet OMB Circular A-127 requirements for automated systems integration and transaction-driven general ledger system capabilities.

- RIS does not record transactions at the United States Government Standard General Ledger (SGL) level (i.e., sub-ledgers do not process transactions consistent with SGL account description and posting requirements).

- OPM's financial management system does not support all program decision-making.

RIS has implemented a new core financial management system to process financial transactions beginning October 1, 1998. OPM anticipates the new system will resolve the above financial management system compliance matters.

RESPONSIBILITIES

Management's Responsibility. Management is responsible for:

- Preparing the financial statements in conformity with the comprehensive basis of accounting described in Note 1 to the financial statements.

- Establishing and maintaining internal control over financial reporting.

- Complying with applicable laws and regulations.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control of financial reporting are to provide management with reasonable, but not absolute, assurance that:

- transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements, and certain other laws, regulations, and government-wide policies identified by the OMB as applicable to the LP;

- assets are safeguarded against loss from unauthorized acquisition, use or disposition;

- transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with applicable accounting principles described in Note 1 to the financial statements; and

- transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.

Auditors' Responsibility. Our responsibility is to express an opinion on the LP financial statements as of and for the year ended September 30, 1998 based on our audit. We are also responsible for considering OPM's internal control over financial reporting related to the LP and testing OPM's compliance with certain provisions of applicable laws and regulations related to the LP that could have a direct and material effect on its 1998 financial statements.

To fulfill these responsibilities, we performed procedures such as the following:

- Examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

- Assessed the accounting principles used and significant estimates made by management.

- Evaluated the overall financial statement presentation.

In planning and performing our audit, we considered OPM's internal control over financial reporting by obtaining an understanding of the agency's significant internal controls, determined whether these internal controls have 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, and not to provide assurance on the internal control over financial reporting. Consequently, we do not provide an opinion on internal controls.

In addition, with respect to internal controls related to performance measures determined by management to be key and reported in the Overview to the financial statements, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 98-08, as amended. 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.

Because of inherent limitations in internal control, fraud may nevertheless occur and not be detected. Also, projection of an evaluation of internal control over financial reporting to future periods is subject to the risk that internal control procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

As part of obtaining reasonable assurance about whether LP's financial statements are free of material misstatement, we performed tests of LP's 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 other laws and regulations specified in OMB Bulletin No. 98-08, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit. Accordingly, we do not express such an opinion.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards*, issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin No. 98-08, as amended. The 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 audit provides a reasonable basis for our opinion.

Distribution

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

KPMG LLP

February 23, 1999
Washington, D.C.

Financial Statements
Fiscal Year 1999

of the

United States Office of Personnel Management

OPM

Prepared by the US Office of Personnel Management
Office of the Chief Financial Officer
April 2000

kpmg

2001 M Street, NW
Washington, DC 200036-3389

INDEPENDENT AUDITORS' REPORT

Director, U.S. Office of Personnel Management:

We have audited the accompanying balance sheet of the Retirement Program (RP), administered by the U.S. Office of Personnel Management (OPM) Retirement and Insurance Service (RIS), as of September 30, 1999, and the related statements of net cost, changes in net position, budgetary resources, and financing (hereinafter collectively referred to as "financial statements") for the year then ended. The objective of our audit was to express an opinion on the fair presentation of these financial statements. In connection with our audit, we also considered OPM's internal control over financial reporting related to the RP and tested OPM's compliance with certain provisions of applicable laws and regulations related to the RP that could have a direct and material effect on its financial statements.

In our opinion, RP's financial statements as of and for the year ended September 30, 1999, are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

Regarding our consideration of internal control over financial reporting, we noted reportable conditions in the following areas:

1. EDP general control environment;
2. Budgetary accounting structure, and
3. Actuarial census data

Regarding our tests of compliance with certain provisions of applicable laws and regulations, with the exception of the Federal Financial Managers' Integrity Act (FFMIA), we noted no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 98-08, *Audit Requirements for Federal Financial Statements*, as amended.

Our conclusions and the scope of our work are discussed in more detail below.

OPINION ON FINANCIAL STATEMENTS

We have audited the accompanying balance sheet of the RP as of September 30, 1999 and the related statements of net cost, changes in net position, budgetary resources, and financing for the year then ended.

In our opinion, the financial statements present fairly, in all material respects, the financial position of the RP as of September 30, 1999, and its net cost, changes in net position, budgetary resources, and reconciliation of net cost to budgetary obligations for the year then ended, in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on RP's financial statements taken as a whole. The information included in the section entitled *Management Discussion and Analysis of the Retirement, Health Benefits and Life Insurance Programs (MD&A)* and the required supplementary information in the schedule entitled *Retirement Program – Required Supplementary Information* is not a required part of the financial statements but is supplementary information required by Office of Management and Budget (OMB) Bulletin 97-01, *Form and Content of Agency Financial Statements,* as amended. Regarding the MD&A, we have considered whether this information is materially inconsistent with the financial statements. Regarding the required supplementary information, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information in the MD&A section of the RP or the required supplementary information and accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that:

- transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with generally accepted accounting principles;
- assets are safeguarded against loss from unauthorized acquisition, use, or disposition;
- transactions are executed in accordance with laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements and certain other laws, regulations and government-wide policies identified by OMB, as applicable to OPM, and
- transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit preparation of performance information in accordance with criteria stated by management.

Because of inherent limitations in internal controls, misstatements, losses, and noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of internal control over financial reporting to future periods is subject to the risk that the internal control procedures may become inadequate because of changes in conditions, or that the effectiveness of the design or operations of the policies and procedures may deteriorate.

We noted certain matters, described in items 1 through 3 below, involving the internal control over financial reporting and its operation that we consider to be reportable conditions under standards issued by the American Institute of Certified Public Accountants and OMB Bulletin No. 98-08, as amended. Reportable conditions are matters coming to our attention that represent significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the RP's ability to record, process, summarize, and report financial data consistent with the assertions of 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. However, we do not consider the reportable conditions described below to be material weaknesses.

The status of prior year findings is presented in Exhibit I. We also noted other matters involving internal control over financial reporting and its operation that we have reported to the management of OPM in a separate letter dated February 11, 2000.

1. EDP General Control Environment

(a) Entity-Wide Security Program

Certain areas in OPM's entity-wide security program could be strengthened. As noted in our prior year report:

- OPM does not have an integrated enterprise-wide security program, and has distributed security functions and responsibilities throughout the organization for data security, general support systems, application systems, and network operations. While different parts of the organization perform different functions, they share common hardware, software, and network platforms, and from a security perspective may be exposed to similar or interrelated vulnerabilities. The current distribution of security functions and responsibilities does not adequately ensure coordinated procedures, risk assessments, and monitoring and response capabilities. In contrast, the opportunity to leverage resources and realize opportunities may not be fully realized with the current decentralized security model.

- OPM has not performed a security risk assessment within the last three years. However, during that period OPM upgraded the mainframe and networking platforms and implemented a new core financial management system. While OPM plans to perform assessments, they have not been scheduled.

- OPM's draft *Information Technology Security Policy* addresses the need for a certification and accreditation process, but there is not one currently in place. OMB Circular A-130 requires "*that agencies consider risk when determining the need for and selecting* *computer-related control techniques. This risk assessment approach should include a consideration of the major factors in risk management: the value of the system or application, threats, vulnerabilities, and the effectiveness of current or proposed safeguards.*" Compliance with OMB Circular A-130 is a critical compliance indicator for the Federal Financial Management Integrity Act, and performance of periodic risk assessments is a critical component of achieving compliance with OMB Circular A-130.

- OPM does not have a formally established, integrated, and robust monitoring and response capability to ensure adequate network and systems security. A limited penetration study found vulnerabilities that were not properly mitigated. OPM immediately responded to these particular vulnerabilities, but does not have a mechanism to identify new risks or to verify that implemented changes were adequate or operating as intended.
- There is no official method of tracking employees that are terminated and/or separated from OPM to ensure that systems security and physical access privileges were appropriately revoked.

An entity-wide security program, including security policies and a related implementation plan, is the foundation of an entity's security control structure and a reflection of senior management's commitment to addressing security risks. Without a well-designed program, security controls may be inadequate; responsibilities may be unclear, misunderstood, or improperly implemented; and controls may be inconsistently applied. Such conditions may lead to insufficient protection of sensitive or critical resources and disproportionately high expenditures for controls over low-risk resources.

(b) Access Control

OPM's EDP access controls require modification. Access controls include physical controls and logical controls. Adequately controlling physical access to computer equipment is an example of a physical control. OPM's physical access control system for the mainframe did not record all security events.

Logical controls include security software programs designed to prevent or detect unauthorized access to sensitive files. We noted certain user account groups with excessive privileges to mainframe resources, which could potentially undermine proper segregation of duties.

Access controls should provide reasonable assurance that computer resources (data files, application programs, and computer-related facilities and equipment) are protected against unauthorized modification, disclosure, loss, or impairment. The objectives of limiting access are to ensure that (1) users only have the access necessary to perform their duties; (2) access to very sensitive resources, such as security software programs, is limited to very few individuals; and (3) employees are restricted from performing incompatible functions or functions beyond their responsibilities.

(c) Application Change Control/Systems Development

Certain controls over the modification of application software programs are deficient. Establishing controls over the modification of application software programs helps to ensure only authorized programs and authorized modifications are implemented. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or "turned off" or that processing irregularities or malicious code could be introduced.

As noted in our prior year report, OPM has not developed a systems development methodology for application software, and the current "RSOD Retirement ADP Standards and Procedures" is missing critical chapters, including data set design and allocation, system development procedures, testing and acceptance, and system software installation and maintenance.

(d) Service Continuity

Losing the capability to process, retrieve, and protect information maintained electronically can significantly impact OPM's ability to accomplish its mission. For this reason, OPM should have procedures in place to protect information resources and minimize the risk of unplanned interruptions, as well as a plan to recover critical operations should interruptions occur. To mitigate service interruptions, it is essential that the related controls be understood and supported by management and staff throughout the organization. OPM has several separate ongoing service continuity-related initiatives and draft plans that need to be finalized, formalized, and properly coordinated so OPM can ensure that critical functions will still be available in the event of a disruption.

Recommendation

We recommend that OPM develop a formal action plan to review and revise its EDP general controls. This plan should address each of the four areas discussed above as well as other areas that impact the general EDP control environment. The plan should also set forth appropriate corrective action steps, assign responsibilities to employees, and establish target completion dates for each action. This plan should be reviewed by the Office of the Inspector General, adopted by executive management of OPM, and provide for periodic review of progress towards achievement of corrective actions.

2. Budgetary Accounting Structure

RIS continues to find it cumbersome to produce accurate and timely year end financial statements for the benefit plans. In fiscal year 1999, RIS implemented a new core financial management system for benefit plan accounting, but did not implement the budgetary accounting structure in its general ledgers. As a result, RIS manually calculated the budget figures in its statements of budgetary resources and financing, and several recalculations were necessary to produce accurate statements. In addition, RIS did not perform reconciliations between the budgetary amounts reported in the financial statements and the corresponding amounts reported on the SF-133 and SF-2108 forms. Without a set of self-balancing accounts to summarize budgetary activity, the risk of reporting inaccurate budgetary figures exists. The lack of a formal budgetary accounting structure resulted in our conclusion that the RP did not substantially conform with the requirements of FFMIA, in accordance with the guidelines contained in OMB Bulletin No 98-08, as amended.

Recommendation

We recommend RIS implement the budgetary accounting structure in the RP general ledger and begin recording budgetary accounting activity consistent with their policy statements. This action will assist RIS in preparing accurate year end financial statements.

3. Actuarial Census Data

The Postal Data File (PDF) contains census data for United States Post Office (USPS) retirees, and is used by OPM in the calculation of RP actuarial liabilities at September 30th. Audit procedures performed on the PDF determined that the PDF had not been updated since September 11, 1998, the last submission by USPS before year end. However, a salary increase had occurred on September 12, 1998 and was not reflected in the PDF. While this salary increase was not large enough to materially affect the estimate of the actuarial liability for September 30, 1999, similar timing differences, should they continue to occur, may affect future years' estimations.

Recommendation

We understand USPS normally submits its year end data approximately two to three weeks prior to year end. We recommend OPM perform year end procedures to inquire whether systemic changes are made to the PDF database after the USPS submission, and to request an update to the PDF data if systemic changes have occurred. OPM should also consider whether other agencies may have similar procedures that could affect data in other databases used by OPM to calculate year end actuarial liabilities.

* * * * *

OMB Bulletin No. 98-08, as amended, requires us to compare material weaknesses disclosed during the RP audit with the material weaknesses reported by OPM in its Federal Managers' Financial Integrity Act (FMFIA) report for the audit period. As a result of this comparison, we noted that the substantial nonconformance with FFMIA reported in the *Compliance with Laws and Regulations* section of our report was not included in OPM's fiscal year 1999 FMFIA report.

COMPLIANCE WITH LAWS AND REGULATIONS

The results of our tests of compliance with laws and regulations, exclusive of FFMIA, performed as part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, disclosed no instances of noncompliance required to be reported herein under *Government Auditing Standards* and OMB Bulletin 98-08, as amended.

Under FFMIA, RP's financial management systems are required to be in substantial conformance with (1) Federal financial management system requirements, (2) Federal accounting standards, and (3) the United States Standard General Ledger (SGL) at the transaction level.

The results of our tests of compliance with FFMIA disclosed instances, described below, where RP's financial management systems did not substantially conform with the requirements discussed in the preceding paragraph:

1. **Federal Financial Management System Requirements.** In accordance with OMB Bulletin No. 98-08, as amended, an agency must meet the following requirements to substantially conform with FFMIA: Federal financial management system requirements; OMB Circular A-127 requirements; requirements published in JFMIP's Federal Financial System Requirements series; and OMB Circular A-130 security requirements. The systems supporting the RP do not meet the following requirements:

   a. *Support the budget execution function and comply with external reporting requirements* – The budgetary account structure for the Federal Financial System (FFS), the core financial management system for the benefit plans, was not implemented as of September 30, 1999. This finding resulted in noncompliance with OMB Circular A-127 and JFMIP's Federal Financial Management Systems Requirements for "Comparability and Consistency," "Application of the SGL at the Transaction Level," "Financial Reporting," and "Support for Budgeting and Performance Reporting."

   b. *Provide adequate system security* – OPM has not performed a security risk assessment within the last three years. However, during that period OPM upgraded the mainframe and networking platforms and implemented a new core financial management system. While OPM plans to perform assessments, they have not been scheduled. In addition, OPM's draft *Information Technology Security Policy* addresses the need for a certification and accreditation process, but there is not one currently in place. Compliance with OMB Circular A-130 is a critical compliance indicator for the FFMIA, and performance of periodic risk assessments is a critical component of achieving compliance with OMB circular A-130.

2. **Federal Accounting Standards.** OMB Bulletin No. 98-08, as amended, states that FFMIA requires financial information used in the preparation of financial statements to be adequately supported by detailed financial records. Detailed financial records exist for all proprietary accounting information; however, the RP has not yet implemented an

accounting structure to support budgetary amounts reported in the RP statements of budgetary resources and financing. The lack of a formal budgetary structure compromises RIS's ability to accurately summarize budgetary data in the RP financial statements.

3. **SGL at the Transaction Level.** OMB Bulletin No. 98-08, as amended, states that FFMIA requires detailed information to be *"captured and summarized so that it follows the SGL descriptions and posting rules and is captured at the level necessary to meet OMB or Treasury reporting requirements and for preparing financial statements."* While detailed records exist for all proprietary accounts, the RP has not implemented an accounting structure to support budgetary amounts reported in the RP financial statements.

Recommendation

To achieve substantial conformance with FFMIA, RIS should implement the budgetary accounting structure of FFS, its core financial management system. RIS should also take actions to address the findings related to systems security required by OMB Circular A-127 and OMB Circular A-130. The resolution of these findings should be a priority for fiscal year 2000.

RESPONSIBILITIES

Management's Responsibility. The Chief Financial Officers (CFO) Act of 1990 requires federal 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 assist OPM in meeting its CFO Act reporting requirements, annual financial statements are prepared for the RP. Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing and maintaining internal control over financial reporting; and
- complying with laws and regulations applicable to the RP, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures.

Auditors' Responsibility. Our responsibility is to express an opinion on the RP financial statements as of and for the year ended September 30, 1999 based on our audit. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 98-08, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinion.

To fulfill these responsibilities, we performed procedures such as the following:

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;

- assessed the accounting principles used and significant estimates made by management; and

- evaluated the overall financial statement presentation.

We are also responsible for considering OPM's internal control over financial reporting related to the RP and testing OPM's compliance with certain provisions of applicable laws and regulations related to the RP that could have a direct and material effect on its 1999 RP financial statements.

In planning and performing our audit, we considered OPM's internal control over financial reporting related to the RP by obtaining an understanding of the agency's significant internal controls, determined whether these internal controls have 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. 98-08, as amended. 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 over financial reporting. Consequently, we do not provide an opinion on internal control.

Our consideration of 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 AICPA and OMB Bulletin 98-08, as amended, and, accordingly, would not necessarily disclose all reportable conditions that are material weaknesses.

In addition, we considered the RP's internal control over the information contained in the required supplementary information schedule entitled *Retirement Program – Required Supplementary Information* by obtaining an understanding of the agency's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls, as required by OMB Bulletin 98-08, as amended. Our procedures were not designed to provide assurance on internal control over the required supplementary information, and, accordingly, we do not provide an opinion on such controls.

With respect to internal controls related to performance measures determined by management to be key and reported in the MD&A to the financial statements, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin 98-08, as amended. 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.

As part of obtaining reasonable assurance about whether RP's financial statements are free of material misstatement, we performed tests of RP's 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. We also performed tests of RP's compliance with certain other laws, regulations and government-wide policies identified by OMB, as applicable to OPM, including the requirements set forth in FFMIA. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to the RP. However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit. Accordingly, we do not express such an opinion.

Additionally, under FFMIA, we are required to report whether RP's financial management systems substantially conform with (1) Federal financial management system requirements, (2) Federal accounting standards, and (3) the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin No. 98-08, as amended.

DISTRIBUTION

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

KPMG LLP

February 11, 2000
Washington, D.C.