



OFFICE OF INSPECTOR GENERAL

Catalyst for Improving the Environment

Audit Report

Audit of EPA's Fiscal 2007 and 2006 (Restated) Consolidated Financial Statements

Report No. 08-1-0032

November 15, 2007

Abbreviations

ASSERT	Automated Self Evaluation and Reporting Tool
BRAINS	Billing & Reimbursable Accounting Information Network System
CNC	Currently Not Collectible
DOJ	Department of Justice
EPA	U.S. Environmental Protection Agency
FFMIA	Federal Financial Management Improvement Act
FMFIA	Federal Managers' Financial Integrity Act
GAO	Government Accountability Office
IFMS	Integrated Financial Management System
IT	Information Technology
mLINQS	Relocation Expense Management System
OARM	Office of Administration and Resources Management
OCFO	Office of the Chief Financial Officer
OIG	Office of Inspector General
OMB	Office of Management and Budget
READ	Registry of EPA Applications and Databases
RMDS	Resources Management Directive System
RSSI	Required Supplementary Stewardship Information
SSFAS	Statement of Federal Financial Accounting Standards
SUSF	Suspense Table



At a Glance

Catalyst for Improving the Environment

Why We Did This Audit

We performed this audit in accordance with the Government Management Reform Act, which requires the U.S. Environmental Protection Agency (EPA) to prepare, and the Office of Inspector General to audit, the Agency's financial statements each year. Our primary objectives were to determine whether:

- EPA's consolidated financial statements were fairly stated in all material respects.
- EPA's internal controls over financial reporting were in place.
- EPA management complied with applicable laws and regulations.

Background

The requirement for audited financial statements was enacted to help bring about improvements in agencies' financial management practices, systems, and controls so that timely, reliable information is available for managing federal programs.

For further information, contact our Office of Congressional and Public Liaison at (202) 566-2391.

To view the full report, click on the following link:

www.epa.gov/oig/reports/2008/20071115-08-1-0032.pdf

Audit of EPA's Fiscal 2007 and 2006 (Restated) Consolidated Financial Statements

EPA Receives Unqualified Opinion

We rendered an unqualified, or clean, opinion on EPA's Consolidated Financial Statements for fiscal 2007 and 2006 (restated), meaning that they were fairly presented and free of material misstatement.

Internal Control Material Weakness, Significant Deficiencies Noted

We noted one material weakness with EPA's Implementation of the "Currently Not Collectible" policy for accounts receivable that caused a Material Understatement of Asset Value and led to the restatement of the fiscal 2006 financial statements. Further, we noted the following six significant deficiencies:

- EPA did not properly compute an allowance for doubtful accounts.
- EPA needs to improve internal controls in recording and accounting for accounts receivable.
- Key applications do not meet federal and EPA information security requirements.
- Access and security practices over critical information technology assets need improvement.
- EPA needs to improve controls over the Integrated Financial Management System Suspense Table.
- EPA did not maintain adequate documentation for obligating accounting adjustments.

Noncompliance With Laws and Regulations Noted

EPA is in noncompliance with regulations relating to reconciling intragovernmental transactions.

Federal Financial Management Improvement Act Noncompliance

We identified two instances of substantial noncompliance under the Federal Financial Management Improvement Act. These noncompliances are also significant deficiencies. Two critical applications did not meet federal and EPA information technology security requirements. Also, key controls associated with certain servers did not comply with federal guidelines.

Agency Comments and Office of Inspector General Evaluation

In a memorandum received on November 9, 2007, from the Chief Financial Officer, the Agency recognized the issues raised and indicated it will take corrective actions.



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

OFFICE OF
INSPECTOR GENERAL

November 15, 2007

MEMORANDUM

SUBJECT: Audit of EPA's Fiscal 2007 and 2006 (Restated)
Consolidated Financial Statements
Report No. 08-1-0032

FROM: Paul C. Curtis 
Director, Financial Statement Audits

TO: Lyons Gray
Chief Financial Officer

Attached is our audit report on the U.S. Environmental Protection Agency's (EPA's) Fiscal 2007 and 2006 (restated) consolidated financial statements. We are reporting a material weakness related to EPA's accounting for delinquent receivables, as well as six reportable conditions. Two of the reportable conditions are financial report systems-related significant deficiencies under the Federal Information Security Management Act of 2002. By definition they are also instances of substantial noncompliance under the Federal Financial Management Improvement Act. We also identified a noncompliance with laws and regulations related to reporting intragovernmental transactions. Attachment 3 contains the status of recommendations from prior years.

The estimated cost of this report – calculated by multiplying the project's staff days by the applicable daily full cost billing rates in effect at the time – is \$2,367,128.

This audit report represents the opinion of the Office of Inspector General, and the findings in this report do not necessarily represent the final EPA position. EPA managers in accordance with established EPA audit resolution procedures will make final determinations on matters in this audit report. Accordingly, the findings described in this audit report are not binding upon EPA in any enforcement proceeding brought by EPA or the Department of Justice. We have no objections to the further release of this report to the public. This report will be available at <http://epa.gov/oig/>.

In accordance with EPA Manual 2750, *Audit Management Process*, you are required to provide us with a written response to the final audit report within 90 days of the final report date. The

response should address all issues and recommendations contained in Attachments 1 and 2. For corrective actions planned but not completed by the response date, reference to specific milestone dates will assist us in deciding whether or not to close this report in our audit tracking system.

Should you or your staff have any questions about the report, please contact me at (202) 566-2523; or Melissa Heist, Assistant Inspector General for Audit, at (202) 566-0899.

Attachments

cc: See Appendix III, Distribution

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Inspector General's Report on EPA's Fiscal 2007 and 2006 (Restated) Consolidated Financial Statements

The Administrator
U.S. Environmental Protection Agency

We have audited the consolidated balance sheet of the U.S. Environmental Protection Agency (EPA, or the Agency) as of September 30, 2007 and 2006 (Restated), and the related consolidated statements of net cost, net cost by goal, changes in net position, and custodial activity; and the combined statement of budgetary resources for the years then ended. These financial statements are the responsibility of EPA's management. Our responsibility is to express an opinion on these financial statements based upon our audit.

We conducted our audit in accordance with U.S. generally accepted auditing standards; the standards applicable to financial statements contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 40, the Agency has restated its financial statements for fiscal 2006 due to material errors in accounting for delinquent debts. In fiscal 2006, EPA adopted OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables*, for accounting for what it considered to be delinquent debts. This policy, as adopted by EPA, required that all receivables outstanding longer than 2 years be removed from the books and put in a memo account. In fiscal 2007, EPA received material collections on those receivables. Further review of correspondence from attorneys indicated that material receivables removed from the books in 2006 were collectible. The evidence was available to the Agency but not considered at the time. As a result, EPA has re-evaluated its decision to adopt OMB Circular A-129, did an in-depth review of the receivables removed from the books, and determined that it needed to restate the fiscal 2006 financial statements in order to properly reflect the value of Agency assets. The Agency restated the fiscal 2006 financial statements to reflect an increase in the net book value of receivables of \$247,413, an increase in liabilities of \$12,910, a reversal of write-offs to expense of \$160,185, and a prior period adjustment of \$74,318.

Due to the material errors found in accounting for delinquent debts, our report on EPA's fiscal 2006 financial statements, issued on November 15, 2006, is not to be relied upon. That report is replaced by this report on the restated fiscal 2006 financial statements. We reported the internal control deficiencies that resulted in the material errors as a material weakness in the Internal Control section of our report.

The financial statements include expenses of grantees, contractors, and other federal agencies. Our audit work pertaining to these expenses included testing only within EPA. Audits of grants, contracts, and interagency agreements performed at a later date may disclose questioned costs of an amount undeterminable at this time. The U.S. Treasury collects and accounts for excise taxes that are deposited into the Superfund and Leaking Underground Storage Tank Trust Funds. The U.S. Treasury is also responsible for investing amounts not needed for current disbursements and transferring funds to EPA as authorized in legislation. Since the U.S. Treasury, and not EPA, is responsible for these activities, our audit work did not cover these activities.

The Office of Inspector General (OIG) is not independent with respect to amounts pertaining to OIG operations that are presented in the financial statements. The amounts included for the OIG are not material to EPA's financial statements. The OIG is organizationally independent with respect to all other aspects of the Agency's activities.

In our opinion, the consolidated financial statements present fairly, including the accompanying notes, in all material respects, the consolidated assets, liabilities, net position, net cost, net cost by goal, changes in net position, custodial activity, and combined budgetary resources of EPA as of and for the years ended September 30, 2007 and 2006 (restated), in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information for earmarked and all other funds presented in the statement of changes in net position is for purposes of additional analysis of the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Review of EPA's Required Supplementary Stewardship Information, Required Supplementary Information, Supplemental Information, and Management's Discussion and Analysis

We inquired of EPA's management as to its methods for preparing Required Supplementary Stewardship Information (RSSI), Required Supplementary Information, Supplemental Information, and Management's Discussion and Analysis, and reviewed this information for consistency with the financial statements. The Supplemental Information includes the unaudited Superfund Trust Fund financial statements for fiscal 2007 and 2006 (restated), which are being presented for additional analysis and are not a required part of the basic financial statements. However, our audit was not designed to express an opinion and, accordingly, we do not express an opinion on EPA's RSSI, Required Supplementary Information, Supplemental Information, and Management's Discussion and Analysis.

We did not identify any material inconsistencies between the information presented in EPA's consolidated financial statements and the information presented in EPA's RSSI, Required Supplementary Information, Supplemental Information, and Management's Discussion and Analysis.

Evaluation of Internal Controls

As defined by OMB, internal control, as it relates to the financial statements, is a process, affected by the Agency's management and other personnel, designed to provide reasonable assurance that the following objectives are met:

Reliability of financial reporting - Transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and RSSI in accordance with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

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

Reliability of performance reporting - 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.

In planning and performing our audit, we considered EPA's internal controls over financial reporting by obtaining an understanding of the Agency's internal controls, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls. We did this as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements and to comply with OMB audit guidance, not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting nor on management's assertion on internal controls included in Management's Discussion and Analysis. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal controls and, accordingly, we do not express an opinion on internal controls.

Our consideration of the internal controls over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be significant deficiencies. Under standards issued by the American Institute of Certified Public Accountants, a significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Agency's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or

detected. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected. We noted certain matters discussed below involving the internal control and its operation that we consider to be significant deficiencies, of which one is considered a material weakness.

In addition, we considered EPA's internal control over the RSSI 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 No. 07-04. Our procedures were not designed to provide assurance on these internal controls and, accordingly, we do not express an opinion on such controls.

Finally, with respect to internal controls related to performance measures presented in *EPA's Fiscal Year 2007 Performance and Accountability Report*, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not express an opinion on such controls.

Material Weakness

EPA's Implementation of the "Currently Not Collectible" Policy for Accounts Receivable Materially Understated Asset Value

During fiscal 2006, EPA materially understated the fiscal 2006 asset value by writing off \$150 million for 31 accounts receivable that were collectible. EPA recorded the write-offs based on implementation of its new "Currently Not Collectible" (CNC) policy. This policy mandated automatic write-off from accounts receivable to a CNC memo account set up for those receivables that had no collection activity for 2 years. After write-off, the Servicing Finance Offices were supposed to review the receivables recorded in the CNC memo account in the Integrated Financial Management System (IFMS) and determine whether they were properly classified as CNC. EPA did not review accounts receivable that were automatically written off. During fiscal 2007, EPA collected \$150 million of receivables written off, including one large receivable of \$127 million. As a result, EPA did not disclose receivables in the 2006 Financial Statements that had a material net realizable value. Federal accounting standards require EPA to record receivables at net realizable value. We consider the control weakness that resulted in EPA undervaluing its fiscal 2006 receivables by \$150 million to be a material weakness.

Significant Deficiencies

Allowance for Doubtful Accounts Calculation Needs Improvement

EPA did not properly compute an allowance for doubtful accounts for fiscal 2006 and 2007. Federal accounting standards and OMB Circular A-136 require agencies to reduce accounts receivable to net realizable value by computing an allowance for doubtful accounts. EPA did not obtain sufficient objective evidence to support the calculation of its allowance estimate on the 2006 re-established receivables and the 2007 receivables.

By not using objective evidence to support their allowance estimates, EPA's financial statements could be misstated.

EPA Needs to Improve Internal Controls in Recording and Accounting for Accounts Receivable

We found 150 errors during testing of internal controls for EPA's accounting for accounts receivable. These errors occurred because EPA had not established or implemented procedures to ensure timely and accurate recording of accounts receivable. Federal accounting standards and EPA policies require accurate and timely recording of transactions. These errors and internal control deficiencies affect the reliability and integrity of accounts receivable on the financial statements and the information used to manage these receivables.

Key Applications Do Not Meet Federal and EPA Information Security Requirements

EPA had not complied with federal and Agency information security standards. In particular, key systems (BRAINS and mLINQS)¹ did not have required contingency plans and signed authorizations to operate. The systems also lacked independent reviews of security controls and security plans. EPA did not review these systems for compliance with Federal Financial Management System Requirements. At the time of our review, EPA also had not recognized these systems in either of the Agency's databases used to track the inventory of EPA applications (ASSERT or READ).² The conditions noted existed because EPA management did not consider these systems "major applications," and thus did not believe it was necessary to comply with published requirements. This is also a substantial noncompliance issue under the Federal Financial Management Improvement Act (FFMIA) of 1996.

Access and Security Practices Over Critical Information Technology Assets Need Improvement

EPA needs to take more steps to support its security practices and access controls over critical information technology (IT) assets. In particular, our field work disclosed concerns in the following management control areas:

- **Disaster Recovery Practices** – EPA had not separated duties for backing up, transporting, and securing critical business data, thereby creating a situation where key business data is susceptible to loss, theft, or misuse without detection. EPA lacks accountability over the use and custody of media drives containing key financial and sensitive personally identifiable information.

¹ BRAINS (Billing & Reimbursable Accounting Information Network System) is used to process accounts receivable; mLINQS (Relocation Expense Management System) is used to process Permanent Change of Station payments.

² ASSERT (Automated Self Evaluation and Reporting Tool) and READ (Registry of EPA Applications and Databases) track the inventory of EPA applications.

- **System Monitoring Practices** – EPA does not monitor critical servers for known vulnerabilities or review system log files for violations of Agency policy. Personnel with significant security responsibility did not receive training on their responsibilities. EPA does not use all available system configuration and security monitoring tools to enforce Agency policies.
- **Server Room Access Controls** – EPA lacks practices to control the access to critical IT assets by non-EPA personnel and other visitors. EPA lacks control over keys to the server room, and the server room activity is not captured or recorded. Critical IT assets are not secured in a manner that would prevent an unauthorized user from tampering with them. For example, unauthorized personnel could physically access the server components and use this access to bypass security implemented to protect the server's data.

Environmental Controls – The server room did not have a correctly installed water shield to protect EPA servers and Uninterrupted Power Supply. The server room did not have sensors that can monitor and alert appropriate personnel of environmental conditions that are hazardous to critical IT assets (excessive humidity, high temperature, and water).

This is also a substantial noncompliance under FFMIA.

EPA Needs to Improve Controls Over the IFMS Suspense Table

EPA needs to improve practices for removing financial transactions that do not process completely in IFMS. IFMS is EPA's core financial accounting system. We found that, monthly, EPA personnel automatically purged all financial transactions over 45 days old from the IFMS Suspense Table (SUSF) without obtaining evidence that the transactions should be deleted, as required by EPA Office of Financial Management Policy Announcement 04-02. This occurred because EPA had not implemented a management oversight process to enforce the Agency's policy requiring EPA offices to explain entries in the SUSF file between 30-45 days old. Although EPA sent notices to the originator regarding the status of its SUSF entries, the originator did not provide responses. In addition, EPA had not put in place a delinquency notice to inform senior EPA officials that uncleared entries remain in the SUSF. In an attempt to reduce the number of excessive out-of-date entries in the SUSF table never reviewed, subsequently deleted, or cleared, EPA personnel said they deleted the financial transactions instead of having the user that originated it do so.

EPA Did Not Maintain Adequate Documentation for Obligation Accounting Adjustments

EPA made adjustments to obligation transactions in IFMS without documenting why the transactions were made and who approved them. This occurred because finance personnel did not understand the policy requirements for documenting adjustments. We have reported similar instances of unsupported transactions since fiscal 2000. EPA policy requires that all financial transactions recorded in the accounting system be supported by

adequate source documentation. Inputting adjusting entries into the Agency's accounting system without adequate documentation increases the risk of fraud, waste, and abuse by increasing the possibility that unauthorized or inaccurate information is entered.

Attachment 3 contains the status of recommendations related to significant deficiencies reported in prior years' reports. We reported less significant matters regarding internal controls in the form of position papers during the course of the audit. We will not issue a separate management letter.

Comparison of EPA's FMFIA Report with Our Evaluation of Internal Controls

OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, requires us to compare material weaknesses disclosed during the audit with those material weaknesses reported in the Agency's FMFIA report that relate to the financial statements and identify material weaknesses disclosed by the audit that were not reported in the Agency's FMFIA report.

For reporting under FMFIA, material weaknesses are defined differently than they are for financial statement audit purposes. OMB Circular A-123, *Management Accountability and Control*, defines a material weakness as a deficiency that the Agency head determines to be significant enough to be reported outside the Agency.

For financial statement audit purposes, OMB defines material weaknesses in internal control as a significant deficiency, or combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

The Agency reported that three material weaknesses had been identified for fiscal 2007, one of which has been corrected. All these material weaknesses were identified by the OIG in the course of this audit, and are described in this report.

Tests of Compliance with Laws and Regulations

EPA management is responsible for complying with laws and regulations applicable to the Agency. As part of obtaining reasonable assurance about whether the Agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. The OMB guidance requires that we evaluate compliance with federal financial management system requirements, including the requirements referred to in the FFMIA of 1996. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to EPA.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion. A number of ongoing investigations involving EPA's grantees and contractors could disclose violations of laws and regulations, but a determination about these cases has not been made.

Our tests of laws and regulations disclosed the following noncompliance issue.

EPA Needs to Reconcile Differences With Trading Partners

As of September 30, 2007, EPA had over \$375 million in net unreconciled differences with 46 of its trading partners for intragovernmental transactions. Treasury policy requires agencies to confirm and reconcile intragovernmental transactions with their trading partners. EPA had difficulty reconciling these differences primarily because of differing accounting treatments and accrual methodologies between federal agencies. EPA's inability to reconcile its intragovernmental transactions contributes to a long-standing government-wide problem that hinders the ability of the Government Accountability Office (GAO) to render an opinion on the Consolidated Financial Statements of the Federal Government. Attachment 2 provides additional details and our recommendations on actions that should be taken on this matter.

Federal Financial Management Improvement Act Noncompliance

Under FFMIA, we are required to report whether the Agency's financial management systems substantially comply with the federal financial management systems requirements, applicable federal accounting standards, and the United States Government Standard General Ledger at the transaction level. An OMB memorandum dated January 4, 2001, *Revised Implementation Guidance for the Federal Financial Management Improvement Act*, lists the specific requirements of FFMIA, as well as factors to consider in reviewing systems and for determining substantial compliance with FFMIA. It also provides guidance to Agency heads for developing corrective action plans to bring an Agency into compliance with FFMIA. To meet the FFMIA requirement, we performed tests of compliance with FFMIA section 803(a) requirements and used the OMB guidance, revised on January 4, 2001, for determining substantial noncompliance with FFMIA.

The results of our work disclosed instances where the Agency's financial management systems did not substantially comply with the applicable federal accounting standard. We identified two financial report systems-related significant deficiencies under the Federal Information Security Management Act of 2002. By definition they are also instances of substantial noncompliances under FFMIA. The noncompliances are: (1) two critical applications did not meet federal and EPA IT security requirements; and (2) key managerial, operational, and technical controls associated with monitoring for system vulnerabilities on, controlling physical access to, and monitoring environmental controls associated with certain servers did not comply with federal guidelines. The noncompliances occurred because management did not consider the two critical applications to be "major applications," did not document performance expectations in written procedures, and did not correct previously identified deficiencies. These issues are also considered to be significant deficiencies. The details of these noncompliances can be found above and in attachment 1.

We reported other less significant matters involving compliance with laws and regulations in position papers during the course of our audit. We will not be issuing a separate management letter.

Our audit work was also performed to meet the requirement in 42 U.S. Code 9611(k) with respect to the Hazardous Substance Superfund to conduct an annual audit of payments, obligations, reimbursements, or other uses of the Fund. We reported a material weakness on accounting for delinquent receivables, which relates primarily to Superfund receivables and other significant deficiencies above.

Prior Audit Coverage

During previous financial or financial-related audits, we reported weaknesses that impacted our audit objectives in the following areas:

- Payroll internal controls.
- General ledger adjustments for receivables transferred to the Cincinnati Finance Center.
- Contingency plans for financial applications.
- Reconciling and reporting intragovernmental transactions, assets, and liabilities by federal trading partner.
- Recording marketable securities.
- Correcting rejected transactions.
- Assessing automated application processing controls for IFMS.
- Security screenings for non-federal personnel.
- Change control procedures for IFMS.

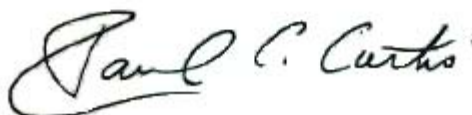
Attachment 3, Status of Prior Audit Report Recommendations, summarizes the current status of corrective actions taken on prior audit report recommendations.

Agency Comments and OIG Evaluation

In a memorandum dated November 9, 2007, the Office of the Chief Financial Officer (OCFO) responded to our draft report.

The rationale for our conclusions and a summary of the Agency comments are included in the appropriate sections of this report, and the Agency's complete response is included as Appendix II to this report.

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



Paul C. Curtis
Director, Financial Statement Audits
Office of Inspector General
U.S. Environmental Protection Agency
November 14, 2007

Material Weakness and Significant Deficiencies

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Material Weakness

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1 – EPA’s Implementation of the “Currently Not Collectible” Policy for Accounts Receivable Materially Understated Asset Value

During fiscal 2006, EPA materially understated the fiscal 2006 asset value by writing off \$150 million for 31 accounts receivable that were collectible. EPA recorded the write-offs based on implementation of its new “Currently Not Collectible” (CNC) policy. This policy mandated automatic write-off from accounts receivable to a CNC memo account set up for those receivables that had no collection activity for 2 years. After write-off, the Servicing Finance Offices were supposed to review the receivables recorded in the CNC memo account in IFMS and determine whether they were properly classified as CNC. EPA did not review accounts receivable that were automatically written off. During fiscal 2007, EPA collected \$150 million of receivables written off, including one large receivable of \$127 million. As a result, EPA did not disclose receivables in the 2006 Financial Statements that had a material net realizable value. Federal accounting standards require EPA to record receivables at net realizable value. We consider the control weakness that resulted in EPA undervaluing its fiscal 2006 receivables by \$150 million to be a material weakness.

OCFO based the CNC policy on OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables*. Circular A-129 made write-off of accounts receivable generally mandatory for delinquent debt older than 2 years. EPA’s implementation of OMB’s policy in fiscal 2006 made write-off of accounts receivable mandatory if delinquent for more than 2 years. EPA’s write-offs included receivables that were considered to be collectible.

As of September 30, 2006, EPA wrote off \$725 million under the policy. In fiscal 2007, we identified collections of \$150 million on previously written-off receivables. The collections included \$127 million for one receivable written off in fiscal 2006. EPA wrote off the receivable even though the case attorney considered the receivable to be fully collectible. The material collections on write-offs indicate that EPA did not value the receivables at the proper net realizable value.

Statement of Federal Financial Accounting Standards (SFFAS) Number 1 prescribes asset valuation. SFFAS states that a receivable should be recognized when a federal entity establishes a claim. An allowance for an estimated uncollectible amount should reduce the gross amount of receivables to its net realizable value.

EPA’s Resources Management Directive System (RMDS) 2540-09,³ Chapter 9, *Receivables and Billings*, stated that the Servicing Finance Offices should use a combination of the percentage analysis method and the specific identification method. The percentage analysis method is used for smaller dollar debts, whereas the specific identification method is used for large debts. Both methods require an objective analysis of the outstanding debt using an aging of receivables (debt) report at the end of each quarter.

³ RMDS 2540-09 Chapter 9 was updated on September 18, 2007, and states that EPA should recognize an allowance for estimated uncollectible amounts to reduce the gross amount of debt to its net realizable value. EPA should individually analyze accounts that represent significant amounts to determine the loss allowance. EPA should assess potential losses for other accounts on a group basis.

The CNC policy required automatic write-off of receivables that were delinquent for 2 or more years even though they might be collected in the future. The policy was not appropriate for valuing the majority of EPA's receivables, such as Superfund cost recovery and grant refund receivables, because they commonly require several years to collect.

EPA's implementation of the CNC policy, as described by RMDS 2540-09 Chapter 9, is in direct conflict with generally accepted accounting standard SFFAS Number 1. RMDS 2540-09 Chapter 9 requires receivables to be removed from the general ledger and classified as CNC if "the debt has been delinquent for two or more years; the debt might be collected in the future and EPA will continue ...collection activity..." SFFAS Number 1 requires assets to be reflected at their net realizable value. By writing off receivables that were considered collectible, EPA was in noncompliance with standards and materially understated receivables.

EPA did not properly implement the CNC policy as required by RMDS 2540-09. In addition to the process that automatically wrote off receivables that had no collections for 2 years, the policy required the Servicing Finance Offices to follow up to determine if the receivable was properly classified. If the debt was not properly classified as CNC, the Servicing Finance Offices were to "reclassify the debt as either open or close-out." In a July 5, 2005, email, EPA's case attorney for the \$127 million settlement stated the receivable was fully collectible. EPA did not act upon the attorney's information to prevent the write-off. The policy also required Receivables and Billings staff in the Reports and Analysis Staff to (1) monitor and evaluate each Servicing Finance Office's quarterly review for quality control and compliance, and (2) ensure that all quarterly reviews collectively support the CNC 9050 general ledger account. EPA did not perform a quarterly review of CNC receivables, nor did Reports and Analysis Staff evaluate items reclassified as CNC. As a result, EPA wrote off some non-delinquent receivables, including receivables that had recent collections. In reports to OMB, EPA also misstated the amount of its delinquent receivables.

Because of the materiality of the collectible accounts receivable that were written off, the continued collection on written-off receivables, and the likelihood such errors will repeat under the current system of controls, we consider the Agency's valuation of accounts receivable to be a material weakness. OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, dated September 4, 2007, defines a material weakness as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. EPA will need to correct this material error by restating the fiscal 2006 financial statements.

Recommendations

We recommend that the OCFO:

1. Change its accounting policy to reflect receivables at their net realizable value. The policy should provide that accounts receivable considered fully or partially collectible should not be written off, but should remain in accounts receivable with an appropriate allowance for doubtful accounts.

2. Restore all CNC receivables to open accounts receivable with an appropriate allowance for doubtful accounts.

Agency Comments and OIG Evaluation

The Agency agreed with our findings and recommendations. The Agency restated its fiscal 2006 financial statements and discontinued the practice of writing off delinquent receivables over 2 years old.

2 – EPA’s Allowance for Doubtful Accounts Calculation Needs Improvement

EPA did not properly compute an allowance for doubtful accounts for fiscal 2006 and 2007. Federal accounting standards and OMB Circular A-136 require agencies to reduce accounts receivable to net realizable value by computing an allowance for doubtful accounts. EPA did not obtain sufficient objective evidence to support the calculation of its allowance estimate on the 2006 re-established receivables and the 2007 receivables. By not using objective evidence to support allowance estimates, EPA’s financial statements could be misstated.

EPA re-established \$704,818,433 of fiscal 2006 accounts receivable that were previously written off as currently not collectible. We tested the allowance estimate on a majority of the re-established high dollar receivables and some smaller receivables. Overall we tested \$661,702,225, or 94 percent, of the amount of the re-established accounts receivable. The table below summarizes the test results.

	No. of Transactions	Receivable Amount	Allowance Amount
Re-established Accounts Receivable at EPA	665	\$704,818,433	\$507,018,368
Amounts Tested	55	\$661,702,225	\$471,982,994
Unsupported Allowance	25	\$201,531,819	\$179,729,256

Source: OIG analysis

For \$201,531,819, or 29 percent of the dollars tested, accounts receivable files did not contain sufficient objective information to support EPA’s allowance estimates.

Objective evidence for allowance estimates should be documented, relevant to the conclusion, and from an authoritative third party. Sufficient evidence may be obtained from external sources such as the case attorney, Program Official, or Department of Justice (DOJ). Examples of objective evidence would be the case attorney’s assessment of the collectibility of an accounts receivable, an assessment by someone in the program office with knowledge of the accounts receivable, or historical documentation on the status of the receivable.

The Agency did not properly update or apply aging percentages in computing the fiscal 2007 allowance for doubtful accounts. We found that EPA did not properly calculate the second and third quarter 2007 allowance for doubtful accounts. EPA did not:

- Reconcile the receivables used in the allowance calculation to the general ledger balances and ensure the calculation included all receivables.
- Use the fiscal 2007 percentages for the second and third quarter allowance calculations. Rather than use the 2007 percentages, EPA substituted substantially higher percentages in several categories.
- Update the percentages based on current data. EPA has not updated its methodology since it consolidated the receivable function at one of its finance centers.

SFFAS Number 1 states that an allowance for estimated uncollectible amounts should be recognized to reduce the gross amount of accounts receivable to its net realizable value. Accounts receivable representing significant amounts should be individually analyzed to determine loss amounts using a systematic methodology. Loss estimates should be based on (a) the debtor's ability to pay, (b) the debtor's payment record and willingness to pay, and (c) the probable recovery of amounts from secondary sources.

Under Generally Accepted Accounting Principles, the Objectivity Principle states that accounting will be recorded on the basis of objective evidence. The Objectivity Principle describes objective evidence as "...different people looking at the same evidence will arrive at the same values for the transaction. Accounting entries will be based on fact and not on personal opinion or feelings."

EPA's RMDS 2540, Chapter 9, Section 10(a), requires Servicing Finance Offices to "derive by age category an estimated percentage of the amount that will not be collected based on the experience of collecting past due accounts."

Appropriate allowance estimates are necessary to recognize accounts receivable at net realizable value. Without appropriate estimates of accounts receivable collectibility, EPA's financial statements and results of operations would not be fairly stated.

Recommendations

We recommend that the OCFO:

3. Prepare the specific identification allowance for doubtful accounts estimates based upon the objective evidence. Such evidence may be obtained from the case attorney, Program Official, DOJ assessment of the receivable's collectibility, or other sources, depending upon the type of receivable.
4. Reconcile the receivables to the general ledger and ensure the allowance for doubtful accounts calculation includes all receivables.
5. Use the percentages applicable to the current year for the year-end allowance for doubtful account percentage analysis calculations.
6. Update the allowance for doubtful account percentages based on current data.

Agency Comments and OIG Evaluation

The Agency agreed with our findings and recommendations.

3 - EPA Needs to Improve Internal Controls in Recording and Accounting for Accounts Receivable

We found 150 errors during testing of EPA's internal controls for accounting for accounts receivable. These errors occurred because EPA had not established or implemented procedures to ensure timely and accurate recording of accounts receivable. Federal accounting standards and EPA policies require accurate and timely recording of transactions. These errors and internal control deficiencies affect the reliability and integrity of accounts receivable on the financial statements and the information used to manage these receivables.

GAO's *Standards for Internal Control in the Federal Government* require accurate and timely recording of transactions and events. OMB Circular A-123, *Management's Responsibility for Internal Control*, states: "control activities include policies, procedures and mechanisms in place to help ensure that agency objectives are met. Several examples include: proper segregation of duties (separate personnel with authority to authorize a transaction, process the transaction, and review the transaction); proper authorization; and appropriate documentation and access to that documentation."

During our testing of accounts receivable, we found the following weaknesses in EPA's internal controls and ability to account for accounts receivable:

- EPA did not timely receive 39 legal documents totaling \$35,344,222 that supported accounts receivable. Further, EPA did not timely record 11 receivables totaling \$20,612,176 after receipt of legal documents. Regional counsel and DOJ did not forward legal documents and supporting documentation to the Finance Office within a reasonable time. Some receivable documents were not received until up to 141 days after the effective date. EPA's RMDS 2550 D, Chapter 14, requires regional enforcement and counsel offices to forward copies of all entered consent decrees and judgments to the finance offices within 3 work days of receipt from DOJ or the court. Finance offices are to record the Superfund accounts receivable in IFMS within 3 work days of receipt of the legal document.
- EPA did not record 10 receivables totaling \$4,068,971 included on regional office and DOJ reports. EPA finance offices did not follow up with regional offices and DOJ to obtain legal documents when collections were received prior to accounts receivable documentation being received and recorded in IFMS. Further, EPA finance offices did not routinely communicate with regional counsel offices, program offices, or DOJ when there were discrepancies between accounts receivable recorded in IFMS and external reports. EPA's *Office of the Comptroller Transmittal No. 00-05: Reporting and Tracking Superfund Accounts Receivable*, dated January 11, 2000, states finance offices must maintain routine communications with the Office of Regional Counsel and program offices to ensure Superfund accounts receivable are recorded timely. Subsequent to our review, EPA researched the receivables, concurred with the auditors, and recorded the receivables in the accounting system. These receivables represent potential monetary benefits to EPA.

- EPA did not record 18 bankruptcy accounts receivable totaling \$9,331,597 at the court-approved claim amount. EPA does not have a uniform process to record bankruptcies. Some bankruptcy receivables were recorded at the assessed claim amount while others were recorded at the collection amount. EPA's *Office of the Comptroller Policy Announcement No. 02-05: Superfund Accounts Receivable: Collection Actions for Delinquent Accounts*, dated August 20, 2002, requires EPA to record bankruptcy accounts receivable at the assessed claim amount. EPA bankruptcy receivables may be based on a pre-existing consent decree, judgment, administrative agreement, Administrative Order on Consent, or a proof of claim. Subsequent to our review, EPA researched the receivables, concurred with the auditors, and recorded the bankruptcy receivables in the accounting system. These also represent potential monetary benefits to EPA.
- EPA recorded 6 federal accounts receivable totaling \$3,162,722 as non federal accounts receivable. EPA staff has not received training on the different types of accounts receivable. SFFAS Number 1 states: "Receivables from federal entities are intra-governmental receivables, and should be reported separately from receivables from non federal entities." In addition, EPA recorded \$226,137 of interest for six receivables in general ledger accounts used for principal instead of general ledger accounts used for interest.
- EPA did not maintain evidence of supervisory review and approval for 5 transactions totaling \$24 million. EPA's management has not established internal control procedures for supervisory review of transactions. EPA's current practice permits accountants and financial specialists to record accounts receivable activity (including corrections and cancellations) directly into IFMS without supervisory review and approval. One such transaction was a \$14 million entry that resulted in an overstatement in accounts receivable at September 30, 2007.

OMB *Circular A-123* cites supervision and the separation of duties as examples of management control standards. It states managers should exercise appropriate oversight to ensure individuals do not exceed or abuse their assigned authorities. GAO's *Standards for Internal Controls* states: "key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them and reviewing the transactions." The standards also state that all transactions and other significant events are to be clearly documented, documentation is to be readily available for examination, and qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved.

- EPA wrote off 70 accounts receivable totaling \$149,900 without supporting documentation, and also exceeded its authority when it improperly wrote off 1 accounts receivable. We statistically sampled 55 transactions and found that EPA wrote off all 55 accounts receivable tested, totaling \$45,246, because EPA could not locate the files. We found that EPA wrote off all 70 transactions in the same manner. Office of Comptroller Policy Announcement No. 93-02, *Policies for Documenting Agency Financial*

Transactions, requires that “all financial transactions recorded in the accounting system be supported by adequate source documentation, and that this documentation be easily accessible.” By not exercising proper collection efforts and maintaining adequate documentation to support the validity of receivables, EPA may have incorrectly written off receivables with net realizable values.

Without adequate supporting documentation, questions arise about the validity and integrity of the financial information in IFMS. Failure to require adequate documentation before adjusting entries are input in the Agency's accounting system increases the risk of fraud, waste, and abuse by increasing the possibility that unauthorized or inaccurate information is entered. The high error rate encountered on the above transactions indicates that controls are not functioning as prescribed. The weaknesses in internal control procedures increase the risk that accounts receivable may not be accurately stated and their status and collectibility may not be accurately reflected.

Recommendations

We recommend that the OCFO:

7. Establish procedures to monitor all tracking reports and follow up with the regional offices and DOJ to obtain receivable documents identified through reconciliations or by receiving collections in advance of the legal documents.
8. Develop uniform procedures to record bankruptcy receivables and establish procedures to properly record federal receivables and their related allowance.
9. Provide staff with training to ensure accounts receivable are accurately recorded in the accounting system.
10. Require standardized recording techniques for accounts receivable items, including proper supporting documentation for transactions, evidence of supervisory review and approval, and segregating duties of entry origination (accountants) and data entry.
11. Determine how the accounts receivable files were lost, and develop procedures to ensure the situation does not repeat. Re-establish the improperly written-off accounts receivable and establish an appropriate allowance for doubtful accounts until determination has been made by management as to whether the debts should be written off.

Agency Comments and OIG Evaluation

The Agency agreed with our findings and recommendations.

4 – Key Applications Do Not Meet Federal and EPA Information Security Requirements

EPA had not complied with federal and Agency information security standards. In particular, key systems (BRAINS and mLINQS)⁴ did not have required contingency plans and signed authorizations to operate. The systems also lacked independent reviews of security controls and security plans. EPA did not review these systems for compliance with Federal Financial Management System Requirements. At the time of our review, EPA also had not recognized these systems in either of the Agency's databases used to track the inventory of EPA applications (ASSERT or READ).⁵ The conditions noted existed because EPA management did not consider these systems "major applications," and thus did not believe it was necessary to comply with published requirements.

Our research and interviews disclosed these key systems play a vital role in EPA's mission. For example, the EPA accounts receivable system processed over \$479 million of financial transactions in fiscal 2007. EPA enters this system's output into IFMS, the Agency's core financial management application, and these entries make up a material amount in the accounts receivable general ledger balance within IFMS. In addition, the system EPA uses to process Permanent Change of Station payments contains sensitive personally identifiable information that is susceptible to identity fraud, if compromised. Management stated EPA would also use this system to process Permanent Change of Station payments for other federal agencies. For these reasons, and the fact that these key systems are critical to EPA's financial mission, management should have taken steps to comply with all mandatory information security requirements. This includes implementing controls to protect the integrity, confidentiality, and availability of the data processed by these applications.

While management made some progress to address weaknesses noted, much still needs to be accomplished. An effective security program needs time to mature. Due to the significance of these weaknesses, EPA cannot be assured that its systems and data are adequately secured. Until these controls are in place, operating, and effectively established, information security management remains a significant deficiency for EPA. OMB emphasizes the importance of these required security controls and prescribes management's reporting requirements for significant deficiencies in OMB Circular A-130, *Management of Federal Information Resources*. With respect to Federal Financial Management System Requirements, the noted weaknesses represent substantial noncompliance with requirements in OMB Circular A-127, *Financial Management Systems*. If these weaknesses are compromised, the potential exists that EPA cannot reasonably ensure it can: (1) provide reliable and timely financial information for managing current operations; and (2) reliably account for its assets so that they can be properly protected from loss, misappropriation, or destruction.

⁴ BRAINS (Billing & Reimbursable Accounting Information Network System) is used to process accounts receivable; mLINQS (Relocation Expense Management System) is used to process Permanent Change of Station payments.

⁵ ASSERT (Automated Self Evaluation and Reporting Tool) and READ (Registry of EPA Applications and Databases) track the inventory of EPA applications.

Recommendations

We recommend that the OCFO:

12. Develop a contingency plan for BRAINS and mLINQS. The plans should be approved by management and have documented annual reviews and testing.
13. Develop a security plan for BRAINS and mLINQS. This should include having both applications comply with all the federal security requirements specified by the National Institute for Standards and Technology, including the completion of the security certification and accreditation process and the resulting formal authorization to operate.
14. Record BRAINS and mLINQS in the Agency's system inventory databases (ASSERT and READ).
15. Enter Plans of Action and Milestones for all the above noted deficiencies in the Agency's security weakness tracking database (ASSERT).

Agency Comments and OIG Evaluation

The Agency agreed with our findings and recommendations and has committed to comply with all systems and security requirements in time for the OIG to verify compliance by December 31, 2007.

5 – Access and Security Practices Over Critical IT Assets Need Improvement

EPA needs to take more steps to support its security practices and access controls over critical IT assets. In particular, our field work disclosed concerns in the following management control areas:

- **Disaster Recovery Practices** – EPA had not separated duties for backing up, transporting, and securing critical business data, thereby creating a situation where key business data is susceptible to loss, theft, or misuse without detection. EPA lacks accountability over the use and custody of media drives containing key financial and sensitive personally identifiable information.
- **System Monitoring Practices** – EPA does not monitor critical servers for known vulnerabilities or review system log files for violations of Agency policy. Personnel with significant security responsibility did not receive training on their responsibilities. EPA does not use all available system configuration and security monitoring tools to enforce Agency policies.
- **Server Room Access Controls** – EPA lacks practices to control the access to critical IT assets by non-EPA personnel and other visitors. EPA lacks control over keys to the server room and the server room activity is not captured or recorded. Critical IT assets are not secured in a manner that would prevent an unauthorized user from tampering with them. For example, unauthorized personnel could physically access the server components and use this access to bypass security implemented to protect the server's data.
- **Environmental Controls** – The server room did not have a correctly installed water shield to protect EPA servers and Uninterrupted Power Supply. The server room did not have sensors that can monitor and alert appropriate personnel of environmental conditions that are hazardous to critical IT assets (excessive humidity, high temperature, and water).

These controls are vital because EPA processes all of EPA's accounts receivable, except those related to grants, contracts, and payroll. EPA uses BRAINS to process over \$479 million in accounts receivable transactions. BRAINS' output is the main data entry source for the Agency's financial management system. EPA also uses another system, mLINQS, that contains personally identifiable information and requires additional controls to detect a security breach and protect the data. EPA plans to use mLINQS to process Permanent Change of Station payments for other federal agencies. Therefore, EPA assumed greater responsibility for (1) providing increased security, and (2) reporting security breaches for mLINQS.

The key cause for many of the noted conditions stems from EPA not stating performance expectations in written procedures. EPA referenced many of the needed controls in its Local Area Network security plan. However, the plan did not assign responsibility or provide detailed steps on how to accomplish the tasks. EPA also had not reassessed its risks, although EPA

underwent consolidation of financial services and increased the use of automation to process financial transactions. EPA's risks also increased because EPA needed to provide increased security to protect personally identifiable information in mLINQS. As a result, these weaknesses placed sensitive information, including financial information and EPA employee information, at risk of inadvertent or deliberate misuse, fraudulent use, improper disclosure, theft, or destruction, possibly occurring without detection.

Federal requirements outline the design for controls reviewed during this audit. Properly designed controls should provide the Agency the ability to reasonably ensure that they can provide reliable and timely financial information for managing current operations. The controls should provide the Agency the ability to account for assets reliably, so that they can be properly protected from loss, misappropriation, or destruction. Our site visit to EPA determined that it is highly likely that if a security incident, breach, or hazardous incident occurred, the event would adversely affect EPA's ability to report financial information as required by federal laws.

Subsequent to audit field work, EPA transferred to the Office of Administration and Resources Management (OARM) the responsibility for managing the service support of its business servers. This includes performing data backups and system maintenance, as well as securing the server room. EPA and OARM use a Memorandum of Understanding to outline the support requirements between the two offices. However, our review of the Memorandum of Understanding noted that it lacked the specific requirements as to how OARM should provide the service support. Since EPA does not have written procedures, EPA does not have benchmarks to measure the service provided by OARM.

Recommendations

We recommend that the OCFO:

16. Update the Memorandum of Understanding with OARM to incorporate requirements for the following key security responsibilities:
 - **Critical server data backup and handling of storage media** – The procedures should delineate separation of duties between the backup tasks and the media handling tasks.
 - **Server scanning and monitoring** – The procedures should outline the frequency for testing servers and require a copy of the test results to be provided to the Cincinnati Finance Center for review.
 - **System logs practices** – The procedures should include guidance on areas such as configuring log sources, performing log analysis, and initiating responses to identified events.
 - **Server room access practices** – The procedures should include steps for logging and escorting visitors and controls over the use of the server room key.
17. Request that OARM implement the use of all available Agency-provided system monitoring reports for operating systems in use on EPA servers and provide the results to EPA management monthly for review.

18. Conduct and document an annual verification and validation of implemented procedures to ensure controls are implemented as intended and are effective.
19. Correctly install the existing water shield over the Cincinnati Finance Center's servers and expand its coverage to include the Uninterruptible Power Supply system.
20. Add controls to protect the Cincinnati Finance Center's servers from the risk associated with unmonitored visitors having access to servers operating critical business applications. This could include relocating the Cincinnati Finance Center's servers to a location controlled by the Finance Center, partitioning the server room in a manner where servers have improved physical access controls, or installing a lockable container within the current server room that is controlled by the Finance Center.
21. Install an environmental monitoring system to protect the Cincinnati Finance Center-owned servers from possible heat and water damage. The system should include sensors that monitor for humidity, temperature, and water.

Agency Comments and OIG Evaluation

The Agency agreed with our findings and recommendations and has committed to comply with all systems and security requirements in time for the OIG to verify compliance by December 31, 2007.

6 – EPA Needs to Improve Controls Over the IFMS Suspense Table

EPA needs to improve practices for removing financial transactions that do not process completely in IFMS. IFMS is EPA's core financial accounting system. We found that, monthly, EPA personnel automatically purged all financial transactions over 45 days old from the IFMS Suspense Table (SUSF) without obtaining evidence that the transactions should be deleted, as required by Office of Financial Management Policy Announcement 04-02. This occurred because EPA had not implemented a management oversight process to enforce the Agency's policy requiring EPA offices to explain entries in the SUSF file between 30-45 days old. Although EPA sent notices to the originator regarding the status of its SUSF entries, the originator did not provide responses. In addition, EPA had not put in place a delinquency notice to inform senior EPA officials that un-cleared entries remained in the SUSF. In an attempt to reduce the number of excessive out-of-date entries in the SUSF table never reviewed, subsequently deleted, or cleared, EPA personnel said they deleted the financial transactions instead of having the user that originated it do so.

The monthly purging of SUSF entries greater than 45 days old could result in relevant financial data being deleted, causing a misstatement in IFMS. Failure to provide explanations of entries in the SUSF table between 30-45 days is a violation of EPA's policy. It also creates a control weakness in that the originator of a transaction has no accountability for the entry after it is created.

Subsequent to the end of the accounting period, EPA personnel completed a review of financial transactions automatically purged from SUSF and provided results of their analysis to the OIG. We conducted a limited review of these results, and did not find instances where EPA personnel inappropriately deleted material financial transactions.

Recommendations

We recommend that the OCFO:

22. Terminate the automatic monthly purging of all SUSF entries that are greater than 45 days old and require the originator of the SUSF entry to delete or clear the entry.
23. Continue sending out monthly SUSF entry reports to all entry originators and their supervisors.
24. Require originators of SUSF entries to provide EPA staff with explanations for why entries greater than 30 days old remain in the SUSF, and provide the estimated date these entries will be cleared. EPA staff should review these explanations and share the information with the originator's supervisor.
25. Develop a delinquency report for all SUSF transactions that are greater than 60 days old and distribute the report monthly to EPA Assistant and Regional Administrators.

Agency Comments and OIG Evaluation

The Agency generally agreed with our findings and recommendations.

7 – EPA Did Not Maintain Adequate Documentation for Obligation Accounting Adjustments

EPA made adjustments to obligation transactions in IFMS without documenting why the transactions were made and who approved them. This occurred because finance personnel did not understand the policy requirements for documenting adjustments. We have reported similar instances of unsupported transactions since fiscal 2000. EPA policy requires that all financial transactions recorded in the accounting system be supported by adequate source documentation. Inputting adjusting entries into the Agency's accounting system without adequate documentation increases the risk of fraud, waste, and abuse by increasing the possibility that unauthorized or inaccurate information is entered.

EPA Comptroller Policy Announcement 93-02, *Policies for Documenting Agency Financial Transactions* (November 1992), requires that all financial transactions recorded in the accounting system be supported by adequate source documentation, and that this documentation be easily accessible. These requirements apply to transactions initially entered into IFMS and to adjustments made to the entries. According to Policy Announcement 93-02:

"Adequately documented" means an independent individual competent in accounting and possessing reasonable knowledge of EPA's operations should be able to examine the documentation and reach substantially the same conclusions as the persons who made and/or approved the entry.

Lack of adequate supporting documentation raises questions about the validity and integrity of the Agency's financial information contained in IFMS. Failure to require adequate source documentation before recording transactions in the Agency's accounting system, the IFMS, increases the risk of fraud, waste, and abuse by increasing the possibility that unauthorized or inaccurate information is entered into the accounting system.

GAO's *Standards for Internal Controls in the Federal Government* state that "... all transactions and other significant events are to be clearly documented, and the documentation is to be readily available for examination." The standards also state "qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved."

During our analysis of obligation transactions, we found two adjustments to entries in IFMS, totaling \$50,055,643, that were not supported by sufficient documentation. There was no explanation as to why the entries were made and no evidence of supervisory approval.

Transaction Date	Transaction Code	Transaction Number	Object Class Code	Transaction Amount Debit (Credit)
01/08/07	CG01	CS39000106	4111	\$(49,305,643)
02/05/07	GO01	BG99732505	4108	\$(750,000)
Total				\$(50,055,643)

Source: OIG analysis

One obligation transaction, totaling \$49,305,643, had no supporting documentation, explanation of the entry, or evidence of supervisory approval. The second obligation transaction, totaling \$750,000, did not have a journal or standard voucher to document the reason for the entry and evidence of supervisory approval.

Lack of adequate supporting documentation affects the validity and integrity of the Agency's financial information. Inputting adjusting entries into the Agency's accounting system without adequate documentation increases the risk of fraud, waste, and abuse by increasing the possibility that unauthorized or inaccurate information will be entered in IFMS. We recognize that the Agency has a policy in place that requires adequate documentation of adjustments to IFMS entries; however, noncompliance with the policy indicates the need for management attention.

Recommendations

We recommend that the OCFO:

26. Reiterate to the Finance Center personnel the importance of adequately documenting adjusting and correcting entries entered in IFMS in accordance with the EPA Comptroller Policy Announcement No. 93-02, *Policies for Documenting Agency Financial Transactions*, and the GAO *Standards for Internal Controls in the Federal Government*.
27. Instruct the Finance Center Directors to ensure that supervisory approval is documented for any adjustments to IFMS entries.
28. During quality assurance reviews, verify that EPA policies on approving and documenting accounting adjustments are being followed.

Agency Comments and OIG Evaluation

The Agency indicated it understood the concerns raised and will emphasize the importance of adequately documenting accounting adjustments to the financial management community and determine the appropriate level of approval for these entries.

Compliance with Laws and Regulations

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8 - EPA Needs to Reconcile Differences with Trading Partners

As of September 30, 2007, EPA had over \$375 million in net unreconciled differences with 46 of its trading partners for intragovernmental transactions. Treasury policy requires agencies to confirm and reconcile intragovernmental transactions with their trading partners. EPA had difficulty reconciling these differences primarily because of differing accounting treatments and accrual methodologies between federal agencies. EPA's inability to reconcile its intragovernmental transactions contributes to a long-standing government-wide problem that hinders the ability of GAO to render an opinion on the Consolidated Financial Statements of the Federal Government.

In addition to the \$375 million, EPA also had \$371 million in differences with Treasury's General Fund. Most of these differences related to custodial liabilities, tax revenues, and accrued collections, as well as adjustments to benefit expenses related to EPA's contributions to the Federal Insurance Contributions Act.

Treasury's fiscal 2007 4th quarter Intragovernmental Activity Detail Report and Material Differences Report showed the following material differences for EPA:

<u>Federal Agency</u>	<u>Difference</u>	<u>Category of Difference</u>
General Services Administration	\$21 million	Accounts Receivable/Payable
Department of Homeland Security	\$46 million	Accounts Receivable/Payable
Department of Homeland Security	\$18 million	Advances to/From Other Agencies
Department of Homeland Security	\$22 million	Buy/Sell Costs/Revenue
Department of Health and Human Services	\$36 million	Advances to/From Other Agencies
Department of Health and Human Services	\$21 million	Buy/Sell Costs/Revenue
Various Federal Agencies	\$211 million	Various Categories

While the Agency has actively worked with its trading partners to reduce differences, material differences continue to exist. Many of the differences result from different accounting treatments and accrual methodologies used by EPA's trading partners. Other situations that contribute to the differences include incorrect trading partner coding, working capital fund revenue recognition, and advance payments in suspense. The differences could be resolved by EPA using the dispute resolution process described in Treasury's Financial Manual, Bulletin No. 2007-03, *Intragovernmental Business Rules*, and making adjustments to address the other situations described above.

EPA reported in the 4th quarter Intragovernmental Activity Detail Report \$19.9 million in differences with seven trading partners in the Transfers Receivable/Payable category. EPA created these differences with allocation transfer entries made in prior fiscal years and has not provided documentation to identify reasons for the transactions. The seven trading partners did not report any reciprocal activity in this category. Treasury's Financial Manual states that the transferor and the transferee shall establish procedures to ensure that transfers are acknowledged and recorded by the transferee in a timely manner. We believe EPA should review and discuss these transfers with its trading partners to comply with Treasury guidance.

During fiscal 2007, EPA increased its efforts to reconcile its intragovernmental activity on a quarterly basis with its partners. Numerous differences persist, and EPA's inability to resolve these differences negatively affects GAO's ability to opine on the Consolidated Financial Statements. EPA should use the dispute resolution process described in the *Intragovernmental Business Rules* and increase its efforts to record proper adjustments with its partners.

Recommendations

We recommend the OCFO:

29. Continue to reconcile the Agency's intragovernmental transactions and make appropriate adjustments to comply with federal financial reporting requirements.
30. Use the resolution dispute process to work with its trading partners on the treatment of accounting and accrual methodology differences.
31. Research prior year Transfers Receivable/Payable entries, and provide information to the Cincinnati Finance Center for discussion with the trading partners to resolve the \$19.9 million differences.

Agency Comments and OIG Evaluation

The Agency agreed with our findings. The also agreed to make appropriate adjustments to comply with federal financial reporting requirements, and use the dispute resolution process to resolve outstanding issues when appropriate.

Status of Prior Audit Report Recommendations

EPA's position is that "audit follow-up is an integral part of good management," and "corrective action taken by management on resolved findings and recommendations is essential to improving the effectiveness and efficiency of Government operations." The Chief Financial Officer is the Agency Follow-up Official and is responsible for ensuring that corrective actions are implemented. Starting in fiscal 2006, OCFO included in its Organizational Assessment Measures a metric for audit follow-up. OCFO management regularly reviews these measures during OCFO's monthly Budget and Performance Review meetings. In fiscal 2007, the Agency took steps to improve its audit follow-up process by certifying completion of corrective actions and improving documentation of corrective actions.

The Agency has continued to make substantial progress in completing corrective actions from prior years. The status of issues from prior financial statement audits and other audits whose findings and recommendations could have a material effect on financial statements and have corrective actions in process are listed in the following table.

Audit Issue Areas with Corrective Actions in Process
<ul style="list-style-type: none"> <p>• Automated Application Processing Controls for IFMS: EPA has made progress towards replacing IFMS, and expects to begin implementation in fiscal 2008. However, until EPA implements the planned replacement automated accounting system that addresses past issues, we will continue to disclose a significant deficiency concerning documentation of the current accounting system and its automated application processing controls.</p>
<ul style="list-style-type: none"> <p>• EPA Needs to Improve Contingency Plans for Financial Applications: Although EPA has made some progress in correcting this deficiency, EPA still needs to update the PeoplePlus personnel contact list within the National Computer Center Critical Application Disaster Recovery Plan. EPA is currently updating this Plan. We plan to follow up to verify that the Plan has been appropriately updated during the fiscal 2008 financial statements audit.</p>
<ul style="list-style-type: none"> <p>• EPA Needs to Improve Reconciliation of Differences with Trading Partners: EPA has decreased its material differences in reconciling intragovernmental transactions with other agencies. However, as described in Attachment 2, <i>Compliance with Laws and Regulations</i>, there remain significant amounts not reconciled with trading partners.</p>
<ul style="list-style-type: none"> <p>• EPA Needs to Strengthen Financial Database Security Oversight and Monitor Compliance: EPA did not complete all the corrective actions in response to Audit Report No. 2007-P-00017 (March 29, 2007), <i>EPA Needs to Strengthen Financial Database Security Oversight and Monitor Compliance</i>, by the end of fiscal 2007. While those actions we reviewed appeared to have addressed our recommendations, we will need to review all corrective actions in response to this audit during the fiscal 2008 financial statements audit to determine if they are effective in correcting the underlying conditions.</p>

Status of Current Recommendations and Potential Monetary Benefits

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status ¹	Action Official	Planned Completion Date	Claimed Amount	Agreed To Amount
1	12	Change its accounting policy to reflect receivables at their net realizable value. The policy should provide that accounts receivable considered fully or partially collectible should not be written off, but should remain in accounts receivable with an appropriate allowance for doubtful accounts.		Office of the Chief Financial Officer			
2	13	Restore all CNC receivables to open accounts receivable with an appropriate allowance for doubtful accounts.		Office of the Chief Financial Officer			
3	15	Prepare the specific identification allowance for doubtful accounts estimates based upon the objective evidence. Such evidence may be obtained from the case attorney, Program Official, DOJ assessment of the receivable's collectibility, or other sources, depending upon the type of receivable.		Office of the Chief Financial Officer			
4	15	Reconcile the receivables to the general ledger and ensure the allowance for doubtful accounts calculation includes all receivables.		Office of the Chief Financial Officer			
5	15	Use the percentages applicable to the current year for the year-end allowance for doubtful account percentage analysis calculations.		Office of the Chief Financial Officer			
6	15	Update the allowance for doubtful account percentages based on current data.		Office of the Chief Financial Officer			
7	18	Establish procedures to monitor all tracking reports and follow up with the regional offices and DOJ to obtain receivable documents identified through reconciliations or by receiving collections in advance of the legal documents.		Office of the Chief Financial Officer		\$4,069.0	\$4,069.0
8	18	Develop uniform procedures to record bankruptcy receivables and establish procedures to properly record federal receivables and their related allowance.		Office of the Chief Financial Officer		\$9,331.6	\$9,331.6
9	18	Provide staff with training to ensure accounts receivable are accurately recorded in the accounting system.		Office of the Chief Financial Officer			
10	18	Require standardized recording techniques for accounts receivable items, including proper supporting documentation for transactions, evidence of supervisory review and approval, and segregating duties of entry origination (accountants) and data entry.		Office of the Chief Financial Officer			

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status ¹	Action Official	Planned Completion Date	Claimed Amount	Agreed To Amount
11	18	Determine how the accounts receivable files were lost, and develop procedures to ensure the situation does not repeat. Re-establish the improperly written-off accounts receivable and establish an appropriate allowance for doubtful accounts until determination has been made by management as to whether the debts should be written off.		Office of the Chief Financial Officer		\$149.9	\$149.9
12	20	Develop a contingency plan for BRAINS and mLINQS. The plans should be approved by management and have documented annual reviews and testing.		Office of the Chief Financial Officer			
13	20	Develop a security plan for BRAINS and mLINQS. This should include having both applications comply with all the federal security requirements specified by the National Institute for Standards and Technology, including the completion of the security certification and accreditation process and the resulting formal authorization to operate.		Office of the Chief Financial Officer			
14	20	Record BRAINS and mLINQS in the Agency's system inventory databases (ASSERT and READ).		Office of the Chief Financial Officer			
15	20	Enter Plans of Action and Milestones for all the above noted deficiencies in the Agency's security weakness tracking database (ASSERT).		Office of the Chief Financial Officer			
16	22	Update the Memorandum of Understanding with OARM to incorporate requirements for the following key security responsibilities: <ul style="list-style-type: none"> • Critical server data backup and handling of storage media – The procedures should delineate separation of duties between the backup tasks and the media handling tasks. • Server scanning and monitoring – The procedures should outline the frequency for testing servers and require a copy of the test results to be provided to the Cincinnati Finance Center for review. • System logs practices – The procedures should include guidance on areas such as configuring log sources, performing log analysis, and initiating responses to identified events. • Server room access practices – The procedures should include steps for logging and escorting visitors and controls over the use of the server room key. 		Office of the Chief Financial Officer			
17	22	Request that OARM implement the use of all available Agency-provided system monitoring reports for operating systems in use on EPA servers and provide the results to EPA management monthly for review.		Office of the Chief Financial Officer			
18	23	Conduct and document an annual verification and validation of implemented procedures to ensure controls are implemented as intended and are effective.		Office of the Chief Financial Officer			

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status ¹	Action Official	Planned Completion Date	Claimed Amount	Agreed To Amount
19	23	Correctly install the existing water shield over the Cincinnati Finance Center's servers and expand its coverage to include the Uninterruptible Power Supply system.		Office of the Chief Financial Officer			
20	23	Add controls to protect the Cincinnati Finance Center's servers from the risk associated with unmonitored visitors having access to servers operating critical business applications. This could include relocating the Cincinnati Finance Center's servers to a location controlled by the Finance Center, partitioning the server room in a manner where servers have improved physical access controls, or installing a lockable container within the current server room that is controlled by the Finance Center.		Office of the Chief Financial Officer			
21	23	Install an environmental monitoring system to protect the Cincinnati Finance Center-owned servers from possible heat and water damage. The system should include sensors that monitor for humidity, temperature, and water.		Office of the Chief Financial Officer			
22	24	Terminate the automatic monthly purging of all SUSF entries that are greater than 45 days old and require the originator of the SUSF entry to delete or clear the entry.		Office of the Chief Financial Officer			
23	24	Continue sending out monthly SUSF entry reports to all entry originators and their supervisors.		Office of the Chief Financial Officer			
24	24	Require originators of SUSF entries to provide EPA staff with explanations for why entries greater than 30 days old remain in the SUSF, and provide the estimated date these entries will be cleared. EPA staff should review these explanations and share the information with the originator's supervisor.		Office of the Chief Financial Officer			
25	24	Develop a delinquency report for all SUSF transactions that are greater than 60 days old and distribute the report monthly to EPA Assistant and Regional Administrators.		Office of the Chief Financial Officer			
26	26	Reiterate to the Finance Center personnel the importance of adequately documenting adjusting and correcting entries entered in IFMS in accordance with the EPA Comptroller Policy Announcement No. 93-02, <i>Policies for Documenting Agency Financial Transactions</i> , and the GAO <i>Standards for Internal Controls in the Federal Government</i> .		Office of the Chief Financial Officer			
27	26	Instruct the Finance Center Directors to ensure that supervisory approval is documented for any adjustments to IFMS entries.		Office of the Chief Financial Officer			
28	26	During quality assurance reviews, verify that EPA policies on approving and documenting accounting adjustments are being followed.		Office of the Chief Financial Officer			

RECOMMENDATIONS						POTENTIAL MONETARY BENEFITS (in \$000s)	
Rec. No.	Page No.	Subject	Status ¹	Action Official	Planned Completion Date	Claimed Amount	Agreed To Amount
29	29	Continue to reconcile the Agency's intragovernmental transactions and make appropriate adjustments to comply with federal financial reporting requirements.		Office of the Chief Financial Officer			
30	29	Use the resolution dispute process to work with its trading partners on the treatment of accounting and accrual methodology differences.		Office of the Chief Financial Officer			
31	29	Research prior year Transfers Receivable/Payable entries, and provide information to the Cincinnati Finance Center for discussion with the trading partners to resolve the \$19.9 million differences.		Office of the Chief Financial Officer			

¹ O = recommendation is open with agreed-to corrective actions pending;
C = recommendation is closed with all agreed-to actions completed;
U = recommendation is undecided with resolution efforts in progress

Agency's Response to Draft Report

November 8, 2007

MEMORANDUM

SUBJECT: OCFO Response to OIG Draft Audit Report, "Audit of EPA's Fiscal 2007 and 2006 (Restated) Consolidated Financial Statements," dated November 8, 2007

FROM: Lyons Gray
Chief Financial Officer

TO: Bill Roderick
Acting Inspector General

Thank you for another opportunity to work with the Office of the Inspector General on the U. S. Environmental Protection Agency's Consolidated Financial Statements and related audit. OCFO's response to the audit report is attached.

The Agency remains committed to sound internal controls and effective policies and procedures. We are continually evaluating ways to improve operations without compromising fiscal integrity. In this regard, I want to personally thank your staff for their willingness to return to Cincinnati in December to verify that we have implemented appropriate corrective actions for the material weaknesses related to information security and physical access to IT hardware.

I look forward to another productive year working with you and your staff. If you have any questions pertaining to operations, please contact Milton Brown, Director of the Office of Financial Services. Contact Lorna McAllister, Director of the Office of Financial Management for questions on the financial statements.

Attachment

cc: Melissa Heist
Paul Curtis
Maryann Froehlich
Joshua Baylson
Lorna McAllister
Milton Brown

OCFO's Response to the Draft OIG Report

"Audit of EPA's Fiscal 2007 and 2006 Consolidated Financial Statements"

Introduction

In FY 2007, EPA completed the consolidation of its major financial services within OCFO's four national finance centers. Transfers included travel payments, vendor and other commercial payments, grant and interagency agreement payments, along with the accounts receivable function. In addition to delivering financial services more efficiently and using automation to gain economies of scale, the goal was to achieve greater compliance with EPA, OMB and other government financial regulations and guidelines. The Agency financial consolidation has reduced Agency costs and has yielded better performance against established financial goalposts.

EPA consolidated all functions to facilitate an employee move into a one-stop-shop center. This new approach will ensure that employees are given consistent information related to their move by experienced staff experts. The centralized web-based relocation program is supported by a COTS software (mLINQs).

In addition, EPA re-evaluated its operating practice of reclassifying certain delinquent receivables after it collected approximately \$150 million in debts previously written-off. The Agency revised its existing policy and operating practices, and reestablished \$725 million in receivables along with appropriate allowances. As a result of these actions, EPA restated its FY 2006 financial statements to reflect the value of the previously reclassified receivables.

EPA also partnered with other Federal agencies to narrow significantly the gap in the differences reported by the Department of the Treasury with the Agency's major trading partners.

OIG Concerns 1 - 3: The OIG made three recommendations on how the Agency records, documents, and values delinquent debt.

OCFO agrees. During fiscal year 2007, EPA collected debt previously written-off and considered not collectible. Consequently, EPA reevaluated its implementation of the policy on delinquent debt. The Agency determined that it cannot forecast collections with absolute certainty due to the nature and unpredictability of external factors that impact a debtor's ability to pay. Therefore, EPA has discontinued the practice of writing off delinquent receivables over two years old.

EPA restored all of these receivables to their net realizable value, which includes an appropriate allowance for doubtful accounts. The fiscal year 2006 column of the financial statements has been updated to reflect these changes.

EPA recognizes that there are improvement opportunities in accounts receivable operating practices including:

- Timely acquisition and maintenance of documentation and supporting evidence;
- Segregation of duties for effective verification and reconciliation;
- Staff training on standard processes, which will support uniformity and consistency; and
- Approach and method to calculate allowances for doubtful accounts.

EPA is actively working to change its business practices to address all of the above.

OIG Concerns 4 - 5: The OIG made two recommendations on information security for two applications and physical access practices and safeguards over IT hardware.

OCFO agrees. The applications in question support accounts receivable work and e-Relocation services to EPA and other government entities. EPA commits to comply with all systems and security requirements in time for OIG to verify compliance by the end of December 2007.

OIG Concern 6: The OIG identified a minor inconsistency in the process for purging and documenting transactions that failed automated system controls established to ensure the integrity of the financial information.

OCFO understands the OIG's concern. EPA evaluated every questionable transaction and determined each transaction was properly processed within a reasonable time. EPA will establish procedures and metrics to ensure transactions are managed appropriately prior to deletion.

OIG Concern 7: EPA did not maintain adequate documentation for obligation accounting adjustments.

OCFO understands the concerns raised by OIG. We will emphasize the importance of adequately documenting accounting adjustments to the financial management community and determine the appropriate level of approval for these entries.

OIG Concern 8: EPA needs to reconcile differences with trading partners.

OCFO agrees. OCFO will make appropriate adjustments to comply with Federal financial reporting requirements and, when appropriate, use the dispute resolution process to resolve outstanding issues.

Distribution

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