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Independent Auditor's Report on Internal Control

To the Architect of the Capitol

We have audited the balance sheet of the Architect of the Capitol as of September 30, 2003, and have issued our report thereon dated August 20, 2004.

We conducted our audit in accordance with auditing standards generally accepted in the United States; the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

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

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the Architect of the Capitol's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted certain matters discussed in the following paragraphs involving the internal control and its operations that we consider to be reportable conditions and material weaknesses.

MATERIAL WEAKNESSES**1. Capitalization of Period Expenses and Equipment in Project Costs**

The Architect of the Capitol (AOC) records construction costs for long lived assets in the Construction Work-in-Progress (CWIP) account. CWIP should include only expenditures which qualify for capitalization (useful life of more than two years) and will ultimately be charged to operations as a depreciation expense once they are placed in service. AOC did not have a policy in place that provided guidance for the proper classification of projects. Our testing identified approximately four projects with total expenditures of \$2,870,900 which did not meet capitalization requirements and should not have been included in CWIP. AOC subsequently analyzed CWIP and charged to operations \$15,250,000, or 4.3% of the September 30, 2003 CWIP balance. These expenditures included \$12,318,000 of period expenditures which were erroneously charged to capitalizable projects, e.g., repair and maintenance, study and plan, and heritage preservation activities, and \$3,115,000 of project expenditures that were below the new \$200,000 threshold.

AOC performs surveys and studies, which are long range plans, feasibility studies, and capital requests, and capitalizes the costs in CWIP. Due to their nature, many of the studies never become viable projects, and AOC has no process to identify when a study is no longer viable and should be charged to operations. We identified approximately two such survey projects with total expenditures of \$680,800. AOC subsequently analyzed CWIP and charged to operations \$1,633,200 of erroneously capitalized surveys. We also identified a \$99,800 equipment purchase that was incorrectly charged to project cost. This resulted in an understatement of the current period depreciation expense and ultimately would have resulted in the depreciable life, as a component of a building, exceeding the useful life of the equipment.

Recommendations – We recommend the following:

- AOC should develop capitalization guidelines and communicate them to the Project Managers in the Construction Management Division (CMD) and the jurisdictions. Project Managers should understand capitalization requirements and communicate that information to accounting as part of the initial project analysis classification. Accounting should review information provided by the jurisdictions, resolve any questions, and maintain project abstracts which justify capitalization decisions prior to capitalizing project costs.
- AOC should document and enforce a policy that determines how to classify studies and for how long to depreciate them. Studies in CWIP need to be identified and classified appropriately.

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- AOC should document and enforce a project capitalization policy that involves Project Managers and ensures that all costs charged to a project relate solely to that project. Regularly meet with CMD and the jurisdictions to understand the scope of projects to determine if projects are placed in service. If they have been, they should be removed from CWIP and capitalized in Property, Plant & Equipment (PP&E).

2. Delayed Transfer of Phased Projects to Property, Plant and Equipment

Many CWIP projects are comprised of phases which are completed and placed in service at different dates, as compared with an integrated project such as a new building, which is completed and placed in service at one point in time. AOC did not account for project phasing. AOC's practice was to maintain a project in CWIP until the budgetary appropriation was substantially expended. This resulted in an overstatement of net assets on the balance sheet and an understatement of period depreciation expense. Our testing identified \$83,060,800 of costs in five projects which were in CWIP after the assets were placed in service. AOC subsequently analyzed CWIP and transferred \$130,694,000 of costs, or 37% of the September 30, 2003 CWIP balance from CWIP to PP&E. The transferred amount consisted of sixteen projects including the five previously identified projects.

Recommendations – We recommend the following:

- AOC should develop and implement an initial capital project review process that includes determining whether a project will be completed in phases. This communication should occur between AOC accounting and CMD and/or jurisdiction project management. AOC accounting should ensure that project management understands the accounting implication of project phased completion and that such projects are identified in advance.
- Project accounting should conduct recurring reviews with project management to ensure that status is communicated and reflected in the accounting records. In service phases should be expeditiously transferred to PP&E.
- AOC should consider establishing project phases in the accounting records to facilitate the transfer of completed phases to PP&E.

3. Allocation of Overhead to Project Costs

We noted general and administrative expenses were erroneously charged to projects through 1996 due to erroneous cost allocation. AOC subsequently removed \$22,201,000 of costs from CWIP and PP&E and adjusted accumulated depreciation \$13,364,152. The errors related to funding mechanisms for temporary employees in the CMD and jurisdictions' overhead cost pools.

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Currently, the CMD overhead cost pool consists of approximately twenty permanent employees. These costs are properly included in project costs based on their relative benefit to each individual project. AOC currently allocates these costs to individual projects based on informal percentages provided by CMD management. This process provides no accountability or documented support for capitalized charges at the project level. The lack of documented support for allocation percentages makes the current process error prone and susceptible to manipulation. Allocations should be based on a systematic and rational process which is repeatable, i.e., the same results can be obtained after the fact, with available information.

Recommendation – AOC should develop and implement a formal construction overhead cost allocation system. Integral to this would be a formal time reporting and collection system, including approvals and reviews, that would accumulate hours spent working on individual projects. This time data would support the proportionate allocation of overhead costs to individual projects. Additionally, AOC accounting should periodically review the overhead cost pool to verify that all components qualify for project capitalization.

4. Accounts Payable Cut-off

AOC does not have a process to compile and record liabilities for goods and services that do not require the preparation of a receiving report. AOC's accounting system automatically recognizes receiving reports as a liability. However, AOC does not prepare receiving reports for professional services, many operating supplies, and maintenance contracts. Accordingly, liabilities are understated as AOC has no process to capture goods and services which have been delivered, or the corresponding liability, without receiving reports. We tested vendor invoices entered into the accounting records in the month subsequent to year-end and identified 15 of 19 invoices, valued at \$1,375,000, which were recorded in the incorrect period. Our statistical sample projected an understatement of liabilities of \$10,856,000, which AOC recorded in the accounting records.

Recommendation – AOC should develop and implement a policy or process that would capture all goods and services received before period-end without receiving reports. Key components of this policy would include polling various jurisdictions for their estimates of period-end accrued liabilities. Vital to this policy would be the jurisdictions' understanding of the concept of accounts payable cut-off and their timely reporting of this information to accounting. Additionally, recurring obligations, such as maintenance contracts and professional services, should be compiled to facilitate the period-end accrual process.

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5. Capital and Operating Leases

AOC does not have an effective policy to identify lease obligations and perform the requisite analyses to determine if they are capital or operating leases for financial reporting. During our testing, we discovered that AOC had not compiled all lease obligations and the accompanying footnote disclosures. As a result, AOC asked all jurisdictions for identification of all known leases. This process resulted in the identification of 39 leases, 11 of which qualified for capital lease treatment. For three of the 11 leases, the lease's value exceeded AOC's capitalization threshold. Therefore, AOC capitalized those three leases and did not capitalize the other eight leases. AOC subsequently recorded the three leases with capitalized asset values of \$45,801,700, of which one lease for the Alternate Computer Facility accounted for \$45,711,100 of the total. Our other testing in accounts payable also identified a June 1997 shared energy performance transaction that we determined was a capital lease with a capitalized asset value of \$8,699,100. Subsequent to the audit, AOC recorded this capital asset in the accounting records.

Recommendation – AOC should implement procedures which facilitate timely and accurate identification of leases. These procedures would need to incorporate information flows from the jurisdictions and the procurement office. Accounting should obtain all relevant financial information (i.e., term, payments, and fair market value of the underlying assets) and perform analyses required to determine if the obligations should be treated as capital or operating leases. Accounting should also update the capital and operating lease footnote disclosures as new leases are identified.

6. Payroll Records

AOC does not maintain their payroll record for a sufficient period of time to match their operating environment. Actual payroll detail is only maintained for 26 records and no standard policy exists for filing of hardcopy documents, e.g., timesheets. Since labor costs are frequently capitalized as part of project costs, this information should be retained until the project is complete. Without an adequate payroll record retention policy, AOC will have difficulty supporting the accounting records and resolving employee payroll disputes.

Additionally, we noted that documentation for personnel changes, including retroactive adjustments, are inconsistently maintained in the personnel records. We identified an undiscovered cumulative \$10,000 overpayment to an employee. The existing process for the documentation, approval, and accurate processing of adjustments was not adequate to prevent and detect this overpayment. Additionally, no payroll audit process existed to identify and collect this overpayment in a timely manner. AOC subsequently identified

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this overpayment, and while they have not waived the overpayment, they have not yet pursued collection. No formal approval process or policies existed to address the decision to not pursue collection.

Recommendation – AOC should retain employee records for the greater of seven years or the duration of the project. AOC should develop standard forms and approvals for personnel record changes, including retroactive adjustments. AOC should also strengthen the review and controls over payroll record changes and perform periodic payroll audits to identify errors in the employee payroll record database. AOC should develop and communicate policies related to payroll overpayments and subsequent collection.

7. Information Technology Controls

AOC does not have adequate Information Technology (IT) controls. Prior to our audit, AOC engaged a contractor to review their Information Technology control structure and practices. We reviewed the contractor's report (the Report) and incorporated their procedures and findings into our baseline assessment. We then performed additional procedures in addition to those identified in the Report.

We identified additional weaknesses in the Information Technology control structure during initial planning walkthroughs. We provided a detailed report as well as a prioritization of findings under separate cover. For a detailed description and recommendations to these findings, refer to the separately issued report.

We summarize some of the salient findings from that report below. Findings are reported under the following general categories:

- Entity-Wide Security Program (SP)
- Access Control (AC)
- Change Control (CC).

Because we could not rely on the essential controls within the aforementioned general categories and the weaknesses noted in the Report, we did not perform all tests as described in the FISCAM. Additional findings may have arisen from the omitted procedures, some of which are included in the Netsec Report.

Entity-Wide Security Program (SP)

This category provides a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of

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the entity's computer-related controls. We noted weaknesses in the following areas relating to AOC's entity-wide security program:

- Formal Comprehensive Information System Security Plan (CFO-SP-2)
- Patching and Vulnerability Policy and Procedures (CFO-SP-3)
- Incident Response Policies and Procedures (CFO-SP-4)
- Formal Policies and Procedures for Periodic Risk Assessments (CFO-SP-1)
- Employee Termination and Transfer Policies and Procedures (CFO-SP-5)
- Certification and Accreditation Policies and Procedures (CFO-SP-6).

Access Control (AC)

Controls within this category limit or detect access to computer resources (data, programs, equipment, and facilities), thereby protecting these resources against unauthorized modification, loss, and disclosure. We noted weaknesses in the following areas relating to AOC's access control:

- Policies and Procedures for Authorized User Lists and User Access Approval (CFO-AC-1)
- Data Tape Library Vulnerabilities (CFO-AC-2)
- Access to Data Center (CFO-AC-3)
- System Security Parameters for Security Access, System Inactivity Log-Off, and Monitoring and Removal of Inactive User Accounts (CFO-AC-5)
- Password Controls Over Inactive Terminals (CFO-AC-6)
- Distribution of User IDs and Passwords (CFO-AC-7)
- Logical Access Controls over Databases (CFO-AC-8)
- Sanitation of Equipment and Media (CFO-AC-10)
- Logical Access Path Controls (CFO-AC-4)
- Encryption (CFO-AC-9).

Change Control (CC)

The controls in this category prevent unauthorized programs or modifications to an existing program from being implemented. We noted weaknesses in the following areas relating to the AOC's change control:

- Restriction of Personal and Public Domain Software (CFO-CC-2)
- Virus Protection (CFO-CC-3)
- Emergency Software Changes (CFO-CC-4)
- System Development Life Cycle (CFO-CC-1).

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Recommendations – We recommend the following:

- Establish a formal IT Continuity of Operations and Disaster Recovery Plan that ensures the appropriate data, software, and hardware is stored off-site.
- Establish a policy requirement and a procedure to authorize and document new account requests, creation, and revocation.
- Establish a policy requirement and procedure that requires the owners/custodians of sensitive data and systems to review the user populations on a periodic basis to ensure that each user only has access to applications and data for which he/she has a current need.
- Create a policy that disallows the use of embedded passwords and establish a procedure for periodic testing to identify embedded passwords that may be introduced into sensitive systems over time.
- Document and approve a procedure for emergency access to production systems by persons who do not have a need to access those systems on a regular basis.
- Modify the local security policy to require segregation of roles and duties according to functional areas.
- Establish a UNIX security configuration and administration guideline.

REPORTABLE CONDITIONS**1. Accounts Receivable Cut-off and Collection of Delinquent Accounts**

AOC has no process to ensure proper cut-off and recording of flag flying fee receivables. The receivable is not recorded until the flag office activity report is received subsequent to period-end, sometimes several months in arrears. AOC does not estimate accounts receivable balance at year-end nor actively seek the activity reports to record the receivable balance.

Additionally, AOC does not have a process to monitor and pursue collection of delinquent receivable balances. During our audit, we identified receivables of \$85,964 and \$42,950 from quasi-private and private organizations that were approximately 32 and 210 days overdue, respectively.

Recommendations – We recommend the following:

- AOC should develop and implement a process to record an accurate cut-off of flag flying fee receivables. This process should include obtaining the flag flying activity report to support the period-end balance or the estimate of the receivable balance.
- AOC should regularly critique accounts receivable and actively pursue collection of overdue balances.

2. Employee Separation Policy and Payroll Processing Accuracy

AOC does not have a formal employee separation policy and process which ensures that system and security accesses are disabled, AOC property is returned, and liabilities due to AOC are collected in the aftermath of voluntary and involuntary separation. AOC has an employee checkout policy in draft form and a pilot program, but no signed policy.

We also observed the following variations in payroll processing controls and data accuracy:

- Employees and supervisors sign payroll System for Time and Attendance Reporting (STAR) report to indicate accuracy and review.
 - One employee did not sign the STAR report. This may allow for the employee to be paid incorrectly.
 - A timekeeper and the Director of Power and Utilities established an agreement that the Capitol Power Plant supervisors not be required to sign the STAR reports due to the various job shifts. The change in policy was not authorized by Human Resources, and the time worked by the employees is unauthorized.
- A deduction for union dues was taken from the employee's pay; however, the employee had not filled out an application form to authorize such a deduction. This may cause the employee to be underpaid.
- Supporting documentation shows an employee to have a different health insurance plan than the plan in the payroll system. The support states the employee requested the family plan while the system states the employee is enrolled in the self plan. This will cause the employee to be overpaid and an insufficient amount contributed to the health insurance plan.

Recommendation – AOC should implement the termination policy to ensure an orderly and secure employment separation. AOC should ensure that all participants in the payroll process understand their roles, and Human Resources and/or Accounting approve any changes to the process. Human Resources should perform periodic audits of payroll information to ensure that it accurately agrees to source documentation.

3. Construction Contract Retainage

AOC has not developed and communicated a contracting risk management policy, specifically as it relates to contract retainage. During our testing, we identified inconsistent usage of retainage on service contracts (i.e., Architects and Project Managers). Further, Project Managers have unilateral discretion as to when and to what degree retainage is reduced as a project progresses without established guidelines. Retainage is a key component of the project financial and performance risk management

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strategy. Without guidelines and standards, AOC will continue to experience variability in the usage of retainage and may assume more project financial and completion risk than is acceptable to management.

Additionally, AOC does not record the retainage liability in the accounting records. The liability and related expense is not recognized until the amount is actually paid. This practice results in understatement of CWIP and contract liability in the accounting records.

Recommendations – We recommend the following:

- AOC should document and enforce a consistent contract risk management policy. This policy would reflect entity risk preferences including definition of contracts requiring retainage, approvals necessary to waive policy, appropriate earlier contract retainage release percentages, and related accounting records' transactions. These steps will help ensure that AOC reduces contract financial and performance risk to accepted levels.
- AOC should record retainage liability as it is incurred.

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


August 20, 2004
Alexandria, VA