

Inspector General's Report

*Audit of the Patent and Trademark
Office's Financial Statements
as of September 30, 1995 and 1994*

INSPECTOR GENERAL'S REPORT ON FINANCIAL STATEMENTS

Mr. Bruce A. Lehman
Assistant Secretary of Commerce and
Commissioner of Patents and Trademarks
Patent and Trademark Office
Washington, D.C.

We have audited the Statement of Financial Position of the Patent and Trademark Office (PTO) as of September 30, 1995 and 1994, and the Statements of Operations and Changes in Net Position, Cash Flows, and Budgetary Resources and Actual Expenses for the years then ended. These statements are the responsibility of PTO's management. Our responsibility is to express an opinion on these Principal Statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 93-06, Audits of Federal Financial Statements. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material 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 audits provide a reasonable basis for our opinion.

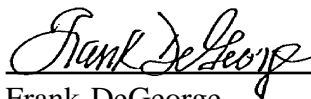
The aforementioned standards also require us to issue reports on PTO's Internal Control Structure and Compliance with Laws and Regulations. We have issued separate reports dated March 8, 1996.

As required by Office of Management and Budget Bulletin No. 94-01, Form and Content of Agency Financial Statements, Note 1 to the Principal Statements describes the accounting policies used by PTO to prepare these statements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the Statement of Financial Position of PTO as of September 30, 1995 and 1994, and the Statements of Operations and Changes in Net Position, Cash Flows, and Budgetary Resources and Actual Expenses for the years then ended, present fairly, in all material respects, the financial position of PTO as of September 30, 1995 and 1994, and the results of its operations and changes in net position, cash flows, and budget and actual expenses for the years ended September 30, 1995 and 1994, in conformity with the accounting policies described in Note 1.

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Our audits were made for the purpose of forming an opinion on the Principal Statements. The information in the other sections of *A Patent and Trademark Office Review* is not a required part of the Principal Statements but is supplementary information required by Office of Management and Budget Bulletin No. 94-01, *Form and Content Agency Financial Statements*. Such information has not been subjected to the auditing procedures applied in the audit of the Principal Statements and, accordingly, we express no opinion on it.



Frank DeGeorge
Inspector General



Lisa Casias, Director
Financial Statements Audit Division

March 8, 1996

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INSPECTOR GENERAL'S REPORT ON INTERNAL CONTROL STRUCTURE

Mr. Bruce A. Lehman
Assistant Secretary of Commerce and
Commissioner of Patents and Trademarks
Patent and Trademark Office
Washington, DC

We have audited the Statement of Financial Position of the Patent and Trademark Office (PTO) as of September 30, 1995 and 1994, and the Statements of Operations and Changes in Net Position, Cash Flows, and Budgetary Resources and Actual Expenses for the years then ended, and have issued our report thereon dated March 8, 1996.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 93-06, *Audits of Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements.

In planning and performing our audit of the financial statements for the year ended September 30, 1995, we considered PTO's internal control structure in order to determine our auditing procedures for the purposes of expressing our opinion on the financial statements and to determine whether the internal control structure meets the objectives identified in the following paragraph. Our consideration included obtaining an understanding of the significant internal control structure policies and procedures and assessing the level of control risk relevant to all significant cycles, classes of transactions, or account balances; and for those significant internal control structure policies and procedures that have been properly designed and placed in operation, performing sufficient tests to assess more fully whether the controls are effective and working as designed.

The management of PTO is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that the Office of Management and Budget, PTO management, or the Inspector General have identified as being significant for which compliance can be objectively measured and evaluated; funds, property, and other assets are safeguarded against loss from unauthorized use or disposition; transactions are properly recorded and accounted for to permit the preparation of reliable

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financial reports in accordance with applicable accounting policies and to maintain accountability over the assets; and data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information. Our evaluation of the controls for performance information was limited to controls to ensure the existence and completeness of the information.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin No. 93-06. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to ensure that the objectives of the internal control structure, as previously defined, are being achieved. We have summarized the reportable conditions below, of which the first two are considered material weaknesses.

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited or material to a performance measure or aggregation of related performance measures may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

A letter dated March 29, 1996, transmitting our audit report to PTO, includes an attachment to our Report on Internal Control Structure which discusses each of the control weaknesses in more detail and provides specific recommendations on actions PTO should consider taking.

Procedures for Accounting for Capital Assets Should Be Improved

PTO has not taken necessary actions to properly account for and safeguard capital assets. After the end of fiscal year 1993, PTO's Office of Finance hired a contractor to compile a subsidiary ledger and to propose necessary adjustments to the general ledger. In order to maintain this ledger, the Office of Finance reviewed fiscal year 1994 and 1995 purchase documentation and proposed adjustments to ensure the accuracy of additions to this ledger for the respective fiscal years. This ledger is currently used to support the capital asset balances in the general ledger but is not used by the Office of Administrative Services to perform annual accountability procedures. The National Finance Center Personal Property System (NFC/PPS) is used for this function. As a result of our current audit procedures, we identified several problems relating to accounting for capital assets that still exist and are detailed below.

Preparation of Capital Asset Schedules and Supporting Capitalization Methodologies

PTO does not have adequate policies and procedures to ensure the acquisition and depreciation of capital assets are recorded properly and on a consistent basis. Specifically, the Office of Finance does not perform an extensive review of monthly status reports and does not keep abreast of new or planned computer systems at PTO. As a result of our procedures, it was determined that approximately \$2.2 million in expenses were erroneously capitalized while \$840,000 in capitalizable costs were expensed. Furthermore due to incomplete asset schedules, PTO failed to record approximately \$655,000 in depreciation expense. In addition, miscommunications between program offices and the Office of Finance resulted in additional errors in recording capital asset transactions.

Disposals

Disposal information is not reported to the Office of Finance to provide for the proper removal of items from the accounting records. The Office of Finance currently performs time consuming manual procedures to determine disposals at year end. Although the Automated Patent Search (APS) system property custodian reported to the Office of Finance that there were no APS disposals, in an effort to identify inventory reconciliation problems, the Office of Finance discovered approximately \$ 11.4 million of APS disposals. Of this, approximately \$3.7 million related to assets disposed during fiscal year 1994. The inventory reconciliation was not performed until four months subsequent to the inventory count. In addition, several weaknesses were found in the count procedures (see below). Furthermore, PTO has not made an assessment to determine when bulk purchases should be removed from the accounting records.

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Controls Over Property (Repeat Condition)

PTO has not completed its efforts to improve controls over property to ensure that it is properly recorded and safeguarded on an on-going basis. PTO does not reconcile the National Finance Center Personal Property System, which is the subsidiary property ledger maintained by the Office of Administrative Services, to the capital asset balance in the general ledger. Acquisitions of property through purchase or lease and disposals of property are not consistently reported to the Office of Administrative Services to enable it to perform its property accountability functions. Physical count procedures currently in place do not ensure that accurate and reliable information is reported to property management in a timely manner.

PTO acquired the assistance of a hired contractor to perform a physical count of APS assets. However, the planning and controls over the physical count of APS assets were inadequate. The inventory listing compiled did not accurately reflect all property held at year end and a significant number of items were noted as "unknown." In addition, inconsistent information and terminology were reported by the count teams. Significant resources were spent by the Office of Finance to perform a partial inventory reconciliation. The Office of Finance was not able to perform a complete inventory reconciliation as of the end of our fieldwork.

In response to our previous audit recommendations, PTO created a project team to determine a uniform process for the management of all personal property. In addition, this team was to address the transmittal of pertinent documentation between PTO offices. Corrective action was to be completed by June 30, 1995. We do not believe that corrective actions have been implemented to resolve the control problems noted above.

Preparation, Analysis and Monitoring of Financial Information Should Be Improved

We identified weaknesses in the following areas relating to the preparation, analysis, and monitoring of financial information that could inhibit managements decision-making process:

General Ledger Coding (Repeat Condition)

PTO continues to have inconsistencies or errors in the coding of purchases of goods or services recorded in the general ledger. Our procedures identified approximately \$3.7 million of capital assets included in expenses that should have been capitalized and approximately \$1.5 million of non-capitalizable assets that were erroneously capitalized. In addition, approximately \$14.7 million in transactions were misclassified between expense accounts and approximately \$ 1.7 million of asset account misclassifications were identified.

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PTO has not fully implemented the new procurement module in its financial system which requires the Office of Finance to review the accuracy of the general ledger coding of purchase transactions. During fiscal year 1995, a portion of the requisitions were processed through Procurement Desktop. Full implementation of the procurement module throughout all program offices is expected during fiscal year 1996. However, a portion of the miscoded transactions identified in our procedures were processed through Procurement Desktop, and the Office of Finance had performed a review of all transactions greater than \$1,000 to ensure proper coding.

Recording Liabilities

PTO's procedures to identify liabilities at year end are inadequate. Approximately \$12.7 million of liabilities were not recorded by PTO. Specifically, \$8.3 million related to deferred revenues. PTO failed to update their assumptions used to calculate deferred revenue. In addition, accruals for services received prior to year end but not billed totaled approximately \$4.4 million.

Budget Execution and Monitoring

PTO did not perform timely reviews of budget to actual information. PTO's controls over the budget execution and monitoring process are inadequate. We identified two situations where PTO program offices overspent amounts in excess of their budgeted operating plans.

One office overspent its budgeted operating plan because it did not forecast its expected personnel expenses at year end. Before year-end, PTO shifted amounts obligated from the unit to another program office. The second example relates to several offices that overspent their Executive Administration and Direction (EXAD) funds. A program officer erroneously used EXAD funds for patent automation purchases. The controls in place to prevent him from spending the money from the wrong budget line were not effective. In addition, due to confusion during a reorganization, approximately \$6 million was budgeted to the wrong office. The Office of Budget analyst responsible for monitoring the offices did not identify the problem until the fourth quarter of 1995.

Cost Analysis

PTO bought out several capital leases citing a buyout savings of nearly \$900,000. However, several deficiencies in the methodology of the calculation resulted in a significant overstatement of savings. These deficiencies included relying on inaccurate numbers provided by the contractor, and including invalid costs. Furthermore, PTO could have saved additional

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monies if the buyout was performed at a later point in time. PTO could not provide adequate support or justification for the potential savings or timing of the buyout. This analysis was prepared without involvement or review by the Office of the Comptroller.

Financial Fluctuation Analysis

PTO's fluctuation analysis comparing fiscal year 1995 year-end balances to prior year-end balances was insufficient and often inaccurate. Specifically, errors were noted in the determination of account balances and explanations for variances were not adequate. This analysis was performed only at the request of the OIG. PTO does not perform account balance analyses as part of their normal operating procedures.

Cash Receipts Should Be Deposited Timely (Repeat Condition)

PTO continues to have delays in the deposits of its cash receipts. At September 30, 1995, the elapsed time from the receipt of funds until their deposit with commercial banking institutions for patents and trademarks was approximately 18 and 14 working days, respectively. This was an increase over the 13 working day lag time for patents at September 30, 1994. However, with the assistance of a contractor hired to process trademark receipts, the lag time for trademarks decreased from the 46 working day lag at September 30, 1994. Unearned fees for checks not deposited as of September 30, 1995 and 1994, amounted to approximately \$41 million and \$40 million, respectively.

The new Revenue Accounting Management System (RAMS) is expected to be fully implemented by October 1996. In our previous audit, management informed us that this new system was expected to solve the problem of untimely deposits. However, during the current audit, we were informed that the implementation of RAMS will not have a significant impact on the receipts processing lag time. PTO management has hired a contractor to review the current processing system and suggest recommendations for "quick fixes." A long-term project is planned to reengineer the receipt process.

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Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above.

We also noted certain other matters, while not considered to be reportable conditions, that we felt warranted inclusion in this report due to their significance and sensitivity. We have summarized these matters below. A letter dated March 29, 1996, transmitting our audit report to PTO, includes an attachment to our Report on Internal Control Structure which discusses each of the control weaknesses in more detail and provides specific recommendations on actions PTO should consider taking.

PTO Should Present Combining Statements

PTO has not performed the necessary procedures to prepare combining statements that could be subject to audit procedures. In fiscal year 1994, PTO presented a Statement of Operations that separated its functions into three activities as supplemental information. For fiscal year 1995, PTO hired a contractor to assist in the preparation of the combining statements for each of its programs (patents, trademarks, and information dissemination). The contractor was responsible for developing allocation methods for the combining statements. Although this was an improvement over fiscal year 1994, PTO recognizes the work performed would not provide for statements that could be subject to our audit procedures.

The importance of proper allocations of costs and expenses to respective lines of businesses is heightened by pending proposals for PTO to become a government corporation. As a government corporation, proposed legislation would require PTO to develop fee schedules for various services, which would include allocations for general and administrative costs. Presenting combining statements will provide users of the financial statements a better understanding of the organization and more meaningful information on the source and use of funds.

Controls over Thrift Savings Plan Contributions Should Be Improved (Repeat Condition)

As noted in previous audits, PTO did not always begin the required contribution of one percent of gross pay to the Thrift Savings Plan (TSP) in the correct period. Based on our recommendation, the Office of Human Resources completed a review to identify and correct. Although PTO stated that the Office of Human Resources would review "the records of all

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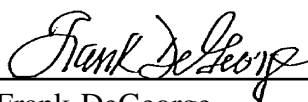
employees," the review was limited to employees hired between July 1992 and December 1993. Our current year procedures identified additional errors in PTO beginning the required contribution of one percent of gross pay in the correct period. In addition, we identified errors in starting employee contributions in the correct period that also affected the timing of matching agency contributions. Subsequent to the issuance of previous audit reports, the Office of Human Resources developed and implemented procedures to prevent errors from occurring in the future. However, these procedures have yet to be documented in its standard operating procedures.

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We have reviewed our findings and recommendations with PTO's financial management and have incorporated their comments as appropriate. Management concurs with our findings and recommendations and will provide an audit action plan in accordance with applicable directives of the Department of Commerce.

We also noted other matters involving the internal control structure and its operation that we have reported to PTO's Associate Commissioner and Chief Financial Officer in a separate letter dated March 8, 1996.

This report is intended for the information of management of PTO, Department of Commerce management, and the Office of Management and Budget. This restriction is not intended to limit the distribution of this report, which is a matter of public record.



Frank DeGeorge
Inspector General

March 8, 1996

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**INSPECTOR GENERAL'S REPORT ON COMPLIANCE WITH LAWS AND
REGULATIONS**

Mr. Bruce A. Lehman
Assistant Secretary of Commerce and
Commissioner of Patents and Trademarks
Patent and Trademark Office
Washington, D.C.

We have audited the Statement of Financial Position of the Patent and Trademark Office (PTO) as of September 30, 1995 and 1994, and the Statements of Operations and Changes in Net Position, Cash Flows, and Budgetary Resources and Actual Expenses for the years then ended and have issued our report thereon dated March 8, 1996.

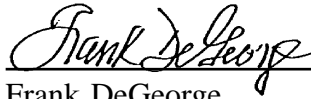
We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget Bulletin No. 93-06, *Audits of Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements.

Compliance with laws and regulations applicable to PTO is the responsibility of PTO's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatements, we tested compliance with those laws and regulations directly affecting the financial statements and certain other laws and regulations designated by the Office of Management and Budget and PTO. As part of our audit, we also obtained an understanding of management's process for evaluating and reporting on internal control and accounting systems as required by the Federal Managers' Financial Integrity Act (FMFIA) and compared the material weaknesses reported in the Department of Commerce's FMFIA report that relate to the financial statements under audit to the material weaknesses and other reportable conditions found during the evaluation we conducted of PTO's internal control system. However, our objective was not to provide an opinion on overall compliance with such provisions.

We noted one instance of immaterial noncompliance that we reported in the Report on Internal Control Structure, dated March 8, 1996, and one immaterial instance of noncompliance that we have reported to management of PTO in a separate letter dated March 8, 1996. Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, PTO complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention to cause us to believe PTO had not complied, in all material respects, with those provisions.

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Frank DeGeorge
Inspector General

March 8, 1996