Smithsonian Institution
Office of the Inspector General

In Brief

Internal Controls Over Cash Management and Banking Activities

Report Number M-06-01, February 14, 2006

Why We Did This Study

Our September 2005 audit of the Institution's bank reconciliation practices and three previous consultant studies raised concerns about the separation of duties in the Comptroller's office, access to financial records, and oversight of banking fees. We examined these issues to determine whether corrective actions had been implemented to strengthen controls over cash management and banking activities. We reviewed duties and access levels for 15 positions in the accounts payable, cash management, and bank reconciliations groups within the Comptroller's office.

What We Recommended

We made 13 recommendations designed to ensure the proper separation of duties; strengthen the review, approval, and documentation of financial system access levels; and ensure periodic validation of current bank charges as well as a monthly analysis of bank fees under future banking arrangements. Management's initial implementation plan fully addressed our recommendations regarding financial system access and bank fees. We have been working closely with the Chief Financial Officer and Comptroller to ensure appropriate corrective actions are taken to address the separation of duties issues.

What We Found

We confirmed that control weaknesses existed in all three areas examined, which could expose the Institution to fraudulent transactions and overpayments, and affect the reliability of information in its financial system. Specifically:

- **Separation of duties.** About 60 percent of the employee positions we reviewed lacked a proper separation of duties. These incompatible duties provided employees the opportunity to misappropriate funds for personal use and to conceal the theft by altering the accounting records. For example, employees could (1) transfer funds out of the Institution and control the related recording of those transactions, (2) modify vendor listings and process payments for vendors, or (3) reconcile and make correcting entries to bank accounts. Also, supervisors did not adequately review outgoing wire transfers, increasing the risk that fraud could occur undetected.

- **Financial system access.** Employees were granted broader access to the automated financial system of the Institution than was necessary to perform their job duties, thereby increasing the risk of theft. This occurred because access levels in the automated financial system are complicated and understood by few, access was granted to employees without evidence of supervisory approval, and managers did not review the appropriateness of employee access levels on a regular basis.

- **Monitoring of banking contracts and fees.** The Institution paid approximately $340,000 in annual bank fees without adequately determining the validity or appropriateness of the charges. Management did not maintain copies of bank agreements or fee schedules and also lacked an internal listing of unit transactions to verify the high volume of miscellaneous service fees charged by its largest banking partners.

For additional information or a copy of the full report, contact the Office of the Inspector General at (202) 275-2244 or visit http://www.si.edu/oig.

Smithsonian Institution

Office of the Inspector General

Date February 14, 2006

To Lawrence M. Small, Secretary
Sheila Burke, P. Burke, Deputy Secretary and Chief Operating Officer

cc John E. Huerta, General Counsel
Alice C. Maroni, Chief Financial Officer
Dennis Shaw, Chief Information Officer
Andrew Zino, Comptroller

From Debra S. Ritt, Inspector General

Subject Management Advisory Report on Internal Control Weaknesses in Cash Management and Banking Activities, Number M-06-01

This report presents the results of our review of the separation of duties in the Office of the Comptroller (OC), access to financial records, and oversight of banking fees—three control areas we identified for further attention during our audit of the bank reconciliation process.[1] Concerns about these controls were also raised in three previous consultant studies performed at the request of the Comptroller.

Cash management, banking, and related accounting functions fall under two divisions within OC: the Financial Analysis and Reporting Division and the Financial Information Processing Division. As of November 21, 2005, these divisions employed 47 individuals and 8 contractors. Of the 47 Smithsonian employees, 5 were assigned to accounts payable, 5 to cash management, 5 to bank reconciliations, and 32 to other functions.

OC oversees the Institution's 35 trust bank accounts, through which approximately $177 million in deposits and disbursements are processed each month.[2] According to the Comptroller, the Institution pays approximately $340,000 annually for these services through a variety of mostly fee-per-transaction services, including lockbox check processing, sorting, and photocopying.[3] At present, OC manually records and reconciles much of the banking activity. The Institution is currently pursuing a new banking arrangement to streamline its banking operations, reduce associated operating costs, and automate banking functions.

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[1] *Audit of Bank Reconciliations*, Office of the Inspector General, September 28, 2005.

[2] The volume of receipts and disbursements is based on December 2004 activity.

[3] Lockboxes are designed for the more efficient and timely processing of remittances and deposit of funds.

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In evaluating controls over cash management and banking activities, we reviewed duties and system access levels for 15 positions[4] in the accounts payable, cash management, and bank reconciliations groups to determine how employees reviewed, processed, and recorded banking and other financial transactions. We also met with Office of the Chief Information Officer (OCIO) representatives and OC managers to determine the process for granting access to areas of the financial system. We assessed how OC monitors fees paid to banks to ensure they are in accordance with approved agreements between the banks and the Institution. We did not attempt to detect fraudulent activity by testing individual transactions where we noted internal control weaknesses. Appendix A further describes our objectives, scope and methodology.

ANALYSES AND RECOMMENDATIONS

As required by Smithsonian Directive 115, units within the Institution must have internal controls in place to ensure that resources are used in a manner consistent with the Institution's mission and that programs are protected from waste, fraud, and mismanagement. Our review identified three internal control weaknesses that could expose the Institution to fraudulent transactions and overpayments, and affect the reliability of information in its financial system:

Separation of duties. Of the 15 accounts payable, cash management, and bank reconciliation positions in OC that we reviewed, 9 individuals (60 percent) could either: (a) control the transfer of funds out of the Institution and the related recording of those transactions; (b) modify the approved vendor list and process payments for vendors through the accounts payable system; or (c) reconcile bank accounts and make correcting entries to those accounts. These incompatible duties provide employees the opportunity to misappropriate funds for personal use and to conceal the theft by altering the accounting records. In addition, in the cash management area, supervisors did not adequately review outgoing wire transfers, increasing the risk that fraud could occur undetected.

Financial system access. Of these same 15 employees, 9 were granted broader access to the automated financial system of the Institution than was necessary to perform their job duties. As a result, employees could process transactions that were outside their assigned job responsibilities, thus increasing the risk of theft. This occurred, in large part, because access levels in the PeopleSoft financial system[5] are complicated; access was granted to employees without evidence of supervisory approvals; and access levels were not regularly reviewed for appropriateness by OC managers.

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[4] The 15 positions included two contractors.

[5] Access levels are established in the PeopleSoft financial system by a hierarchy of settings. Roles establish a user's ability to perform a specific function or task. For each role, there are pre-established permission lists and for each permission list there are established preferences. Roles, permission lists, and preferences can be modified by the OCIO.

Monitoring of banking contracts and fees. The Institution paid approximately $340,000 in annual bank fees without reviewing the approved bank agreements to establish the validity or appropriateness of the charges. A 2004 consultant study raised concerns that the Institution may have paid excessive and unusual fees for lockbox and other depository services, which may explain why the Smithsonian was charged higher rates than the national averages for some of the bank services. The Comptroller acknowledges that oversight of bank service fees has been a longstanding issue, which he has been working to resolve since he was hired by the Institution in July 2004. By September 2005, OC had obtained copies of the bank agreements for most of the smaller banks. However, it was unable to obtain previous fee schedules or a copy of its agreement with its largest banking partner, the Bank of America, which accounted for over 80 percent of the annual banking service fees. OC also lacked an internal listing of transactions to verify the accuracy of fees charged by the Bank of America. It was not until the end of this review in December 2005, that OC obtained a fee schedule for Bank of America to use in future analyses of bank charges.

We provided management with an informal draft of this report in the latter part of November 2005 and entered into extensive discussions with the Comptroller on the report findings and compensating controls to mitigate the impacts of the control weaknesses we identified. Our findings did not change as a result of these discussions, but we made minor technical changes to the informal draft and refined several recommendations before issuing the formal draft on January 13, 2006.

On January 27, 2006, management provided us with its formal response to our draft report, which is contained in its entirety in Appendix B. The response indicated concurrence with 10 recommendations, partial concurrence with the remaining 3, and disagreement with several of our conclusions and our characterization of OC staffing levels and banking fees. We carefully reviewed management's concerns with the report and continue to believe our conclusions and characterization of the facts are accurate. Management proposed actions that should strengthen internal controls over system access levels and oversight of bank fees. However, corrective actions proposed by management to ensure the proper separation of duties are not fully responsive to our recommendations in this area. A detailed discussion of the internal control weaknesses and management's response to our analysis and recommendations is included in the following sections.

Critical Duties are not Adequately Separated within the Office of the Comptroller

The objective of separating duties is to make certain that employees do not have control over multiple phases of a transaction. The Office of Management and Budget's Circular A-123, ***Management's Responsibility for Internal Control***, states that key duties and responsibilities for authorizing, processing, recording, and reviewing official agency transactions should be separated among individuals. When there is a good separation of duties, fraud cannot occur undetected unless there is collusion between two or more employees. Therefore, managers should ensure that individuals are not assigned incompatible duties that give them control over multiple phases of a transaction. Managers, themselves, also should not have the capability to authorize, process, and

review the same transactions.

Our evaluation disclosed that 9 or 60 percent of the 15 employees sampled performed duties that allowed them to control multiple phases of a transaction. As discussed below, these employees were divided among the cash management, accounts payable, and bank reconciliations areas of OC under the Financial Analysis and Reporting Division and Financial Information Processing Division.

- In the cash management group, two employees, who annually execute tens of millions of dollars in wire transfers, are responsible for both executing the transfers and recording them in the accounting system. This arrangement provides the opportunity to execute wire transfers to fictitious payees and then conceal the identity of the true payee(s). For example, employees can send a wire to their own account and then improperly record it as a payment to a vendor or other bank account. The person reconciling the bank account would likely not detect this fraud because the amount recorded in the ledger would correspond to the amount paid by the bank. This is of particular concern because employees can wire (over the phone or by Internet) millions of dollars without verification or approval from the supervisor prior to the bank's execution of the transaction. Also, few limits have been established for the dollar amount and number of wires that can be initiated each day. The Cash Management Officer told us that he began to approve some Internet wires in November 2005. While this is a good first step, we believe that wires transacted over the phone should also be approved before funds are transferred. Further, wires in excess of $1 million should be approved by progressively higher levels of authority, such as the Manager of the Financial Information Processing Division and the Comptroller. These approval levels should be communicated to the banks as a requisite for accepting the transfers, and OC should conduct periodic reviews of the support and approvals for wire transfers and approval limits.

- The accounts payable manager and two other employees in accounts payable can authorize the processing of payments approved by the units, review accounts payable transactions, and create and adjust vendor files in the financial system. The accounts payable manager told us that he had both recorded and approved entries in the financial system either when employees were absent or to meet workload demands during peak periods. Because of these privileges, the accounts payable manager could direct payments to a fictitious vendor and conceal the transaction by altering the accounting records. The two other accounts payable employees were assigned access levels that became inappropriate after their duties changed. One of these individuals did not have his accounts payable access removed when he was reassigned vendor maintenance responsibilities. The other individual was a contract employee who was rotated among various duties without modifying her access levels. Because system access levels of these employees were not reviewed and modified after their duties changed, these individuals could both access vendor maintenance files and schedule vendor payments.

- Four employees in the bank reconciliations group are responsible for reconciling bank accounts and correcting accounting records. In our recent audit of bank reconciliations, we found one of these employees had both performed the reconciliation and cleared reconciling items for the CIGNA account. These incompatible responsibilities would allow this employee to force bank account reconciliations into balance with the accounting records through improper entries into the accounting system. Subsequently, the Institution dropped CIGNA as its medical provider.

The lack of proper controls was previously reported in a 2004 PricewaterhouseCoopers LLP study.[6] The study identified a lack of separation of duties within OC, noting instances where the same individual was preparing and posting journal entries, and the absence of supervisory review of the entries. The consultant concluded that the focus of the office was on processing transactions rather than on controlling those processes to ensure that information was properly recorded and reviewed. The study advised OC that it should implement a policy where all journal entries are reviewed and signed by a supervisor. We agreed that all journal entries should be reviewed and approved. In discussing this issue with the Comptroller, he indicated that available resources were insufficient to review every journal entry. Recognizing these constraints, at a minimum, the Comptroller should ensure that non-routine journal entries as well as those in excess of $100,000 are reviewed and approved.

The consultant also suggested as a best practice that the Institution's Office of the Treasurer assume responsibility for wire transfers and bank callback verification procedures, and that limits be set on the amount of money that can be transferred without additional review. Subsequently, the Institution elected not to shift these responsibilities to the Office of the Treasurer because it believed it had adequate mitigating controls in place and that the related accounting function would be better managed in OC. Because, as discussed above, adequate controls over wire transfers were not in place, we are recommending a series of actions that should strengthen oversight of wire transfers should the Institution keep this function within OC.

In addition to the consultant's observations, we found the inadequate separation of duties within OC has, in large part, resulted from multiyear budget reductions. According to the Comptroller, at the start of FY 2002 OC had about 90 employees. Due to staff reductions and transfers to other units, staffing levels had declined by the end of fiscal year 2005 to about 47 employees. To compensate for staffing shortages supervisors have had to review, record, and process transactions to meet workload demands.

The staffing shortages also have caused OC to rely heavily on contractors, which has weakened the control environment. Further, the high turnover of contract staff created vacancies in critical positions, requiring permanent employees to perform multiple phases of transactions as well as expend scarce resources to train temporary staff. For example, in an attempt to balance the workload, three employees assigned bank reconciliation duties were given access to the accounts payable module to process intragovernmental

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[6] ***Smithsonian Institution Internal Controls Review – Phase II***, PricewaterhouseCoopers LLP, December 2004.

payments and collections. This access allowed them to process all types of accounts payable transactions outside of the accounts payable supervisory review process.

OC's heavy reliance on contract staff was highlighted as an area for improvement in Booz Allen Hamilton's ***Focused Workforce Analysis*** report[7], which noted that the Institution would benefit from replacing some of its contractors with permanent staff. The consultant reported that the current financial management workload exceeded workforce resources, and that the Institution needed to define the number of staff required to adequately perform financial roles within the Institution.

The Comptroller acknowledges that his office's reliance on contractors had resulted in many data entry errors, and he is taking steps to mitigate this situation. Senior managers, through the Workforce Hiring Action Plan process, have strengthened the Office of the Comptroller's staffing by converting four positions from contract to permanent staff, adding three new positions, and upgrading another position. In September 2005, the Comptroller hired a Cash Management Officer who has started approving some of the wire transfers from the Institution's bank accounts. However, this practice has not been formalized in OC written procedures, and not all wire transfers are approved by the Cash Management Officer. Further, despite the additional positions, in our view, the staffing levels in OC are still inadequate to manage the workload.

RECOMMENDATIONS

Given the increased emphasis on internal controls by the Office of Management and Budget, and the potential for significant losses through wire transfers, we recommend the Chief Financial Officer (CFO):

1. Review functions currently performed within OC and take steps to ensure that employees do not have control over multiple phases of a transaction, consistent with SD 115.

2. Require the Cash Management Officer to approve all outgoing wire transfers before funds are transmitted. In addition, require that wire transfers in excess of $1 million be approved by the Manager of the Financial Information Processing Division and those over $10 million be approved by the Comptroller, or in their absences by designated alternates.

3. Instruct the banks not to accept wire transfers from the Institution's bank accounts without authorization from the Cash Management Officer, the Manager of Financial Information Processing Division or the Comptroller, or in their absences by designated alternates.

4. Require a monthly review of wire transfers to ensure they are properly supported and approved.

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[7] ***Focused Workforce Analysis***, Booz Allen Hamilton, September 2005.

5. Ensure that non-routine journal entries as well as those over $100,000 are reviewed and approved by a supervisor.

System Access Levels were Granted in Excess of Job Responsibilities

In April 2005, PricewaterhouseCoopers issued a report[8] summarizing the results of its review of security controls associated with the Institution's financial system (PeopleSoft). After reviewing approximately 1,200 Institution-wide accounts, PricewaterhouseCoopers found that individuals in OC and OCIO had been granted inappropriate access to different sections of the production environment, such as vendor management or accounts payable, based on their respective job positions or responsibilities. This occurred due to the complexity of PeopleSoft roles and permission lists.

In response to the report, the Comptroller, in coordination with OCIO, removed "system administrator" access for a small subset of employees, and a number of queries were developed to facilitate periodic review of user access. Nonetheless, our review disclosed that 9, or 60 percent, of the 15 staff in OC sampled still had access to areas of the financial reporting system that were incompatible with their primary job responsibilities. For example, three employees in the accounts payable group had access to both vendor maintenance and vouchers payable sections of the financial system, which could allow fictitious payments to be processed and concealed. In addition, four employees in the bank reconciliations group who were responsible for reconciling bank statements had access to the general ledger, which could allow them to improperly modify the accounting records.

We also found that the OC manager for accounting systems integration was granting system access to OC staff without evaluating whether access levels were compatible with employee job duties. The manager told us he was not trained on the configuration of security access levels within the PeopleSoft financial system and has not been provided information on job duties that would allow him to determine where responsibilities are incompatible with system access.

The security access form used to assign system permissions also does not clearly define access permissions being requested. For this reason, the manager relies on employees' direct supervisors to perform that review, and only signs the security access forms because his predecessor signed them. However, we found no evidence that supervisors reviewed and approved systems access requests.

The manager also did not keep copies of the approved system access forms sent to OCIO, or periodically review access profiles. Smithsonian Directive 301 requires, at a minimum, that unit managers review user access profiles at least annually or when employees change duties to ensure appropriate roles and responsibilities are assigned to each user in the financial system. Despite this requirement and several requests from OCIO, OC had not provided OCIO with a list of its employees who should have their system access levels

[8] ***Security Review and Penetration Testing of Financial Systems***, PricewaterhouseCoopers LLP, April 2005.

modified.
In addition, the manager told us that he does not approve all user systems access requests. User access requests for the purchasing and budget areas of the financial system are approved by the Office of Contracting and the Office of Planning, Management and Budget. These units, with the assistance of an OCIO employee, were evaluating whether system access requests for purchasing and budgeting functions were creating separation-of-duty conflicts. We determined this evaluation process was not always effective in identifying potential conflicts. For example, employees provided access to the budgeting module of PeopleSoft should not have access to the purchasing module because it could enable them to make unbudgeted purchases and then mask them by changing the budget records.

RECOMMENDATIONS

To ensure the Institution has implemented access controls for its financial system that more properly reflect user responsibilities, we recommend the CFO:

6. Require OC supervisors to review and sign system access forms before they are sent to OC's manager for systems integration to ensure that OC employees are granted only the access needed to perform their jobs.

7. Require the systems integration manager retain approved system access requests; and as required by Smithsonian Directive 301, annually review the appropriateness of system access levels granted OC employees and work with OCIO to modify access levels, where appropriate. Because OC had not provided OCIO a list of needed system access modifications for its employees, OC should do so no later than 30 days from the date of this report.

8. Assign responsibility for reviewing separation of duties related to PeopleSoft system access levels between the various CFO departments to ensure that no one individual can control multiple phases of a transaction.

9. Ensure that the financial systems integration manager is provided adequate information, training, and support from OC and OCIO on PeopleSoft financial system access levels and employee job duties to allow him to appropriately evaluate system access requests.

We recommend the Chief Information Officer:

10. Work with OC to more clearly define system access levels, roles, and permissions for OC staff and revise access forms to better describe the respective financial system access levels.

Banking Fees were Paid without Ensuring their Validity or Reasonableness

An important component of cash management is proper oversight of banking fees. We found that the OC had been paying approximately $340,000 annually for numerous banking fees without adequately determining the validity or reasonableness of the fees. OC could not conduct fee reviews because it did not maintain records of the approved agreements with the banks. The bank agreements also were not retained by the Office of Contracting or the Treasurer.

The lack of documentation to monitor bank fees is troubling in light of fee irregularities identified by an October 2004 study by Mitchell & Titus, LLP.[9] The consultants reported they found disturbing the number of fees assessed for what appeared to be the same transactions. For example, the Smithsonian was billed multiple fees by both Riggs Bank (now PNC) and Bank of America for receiving, depositing and recording checks received in lockboxes. Mitchell and Titus also reported that both banks, combined, charged 63 types of miscellaneous service fees that were outside of industry norms. Additionally, it identified unusual billings for excessively high volumes of inquiries for information. For example, the Smithsonian was charged for inquiry fees based on an activity level of about 17,000 inquiries monthly. The consultants reported that "the Smithsonian was also billed unexpected charges for walk-in deposit fees on lockboxes and other questionable services, such as negotiability reviews and deposit preparation."

In looking at the high volume of miscellaneous fees that the Bank of America charged the Institution, we noted that the units were directly ordering services from the banks without approval from OC. These services included inquiries, photocopying, and other miscellaneous services. Because these services were charged on a per-transaction basis, unit actions contributed to a higher level of monthly service charges. We also found that OC had no independent source of information, such as an internal transaction-level listing, to verify or analyze the number of unit transactions being charged or to identify which units were responsible for the transactions. Absent detailed activity-level data, the Comptroller could not determine which units were ordering banking services and thus missed an opportunity to reduce operating costs. To address this, the Comptroller told us he plans to direct the banks to either not accept or to limit the miscellaneous services they provide to the units.

In September 2004, OC requested copies of the current agreements from the banks. OC subsequently acquired many of the banking agreements for the smaller banks and most recently the fee schedule from the Bank of America, the Institution's largest banking partner. However, neither the Bank of America nor the Comptroller could ultimately produce a copy of any contract or previous fee schedule, which is needed to determine whether previous payments to Bank of America were appropriate. However, with the current fee schedule the Comptroller should be able to review the validity and reasonableness of future charges.

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[9] ***Assessment of Banking Relationships and Cash Management Practices***, Mitchell & Titus, LLP, October 2004.

RECOMMENDATIONS

We recommend the CFO:

11. At least quarterly, verify that charges for banking services are valid and reasonable in accordance with the Institution's current agreements with the banks. Ensure a provision is incorporated into future banking agreements to allow for a monthly analysis of bank fees.

12. Direct the Institution's current banking partners to either reject or limit miscellaneous services provided to the units until new banking arrangements are established.

13. Formalize the controls recommended to OC in this report into a written policy to ensure current and future OC employees have appropriate operating guidance and to better document controls over cash management and other financial management activities.

MANAGEMENT COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

We provided management with an informal draft of this report in November 2005 and entered into extensive discussions with the Comptroller on the report findings and compensating controls to mitigate the impacts of the control weaknesses we identified. Our findings did not change as a result of these discussions, but we made minor technical changes and refined several recommendations before issuing the formal draft on January 13, 2006.

On January 27, 2006, management officials provided formal written comments indicating disagreement with several of our conclusions and the report's characterization of OC staffing levels and banking fees. Specifically, management disagreed that individuals performing bank reconciliations should be restricted from having general ledger access to those accounts based on current staffing limitations and its confidence in existing processes. Management also expressed concern that the report did not explain that OC performed bank reconciliations and cleared reconciling items for the Institution's CIGNA account because the Office of Human Resources (OHR) had ceased to perform this function. Further, management disagreed that the Comptroller's monitoring of bank contracts and fees was weak given his professional experience and the extensive analyses he performed of the fees. Management also believed the report inaccurately described bank charges for inquiries.

We carefully reviewed management's concerns with the report and continue to believe our conclusions and characterizations of the facts are accurate and appropriate. Although management asserts that our report contains "serious inaccuracies," we correctly reported that five employees were assigned to the bank reconciliation function in OC. The sixth person performing bank reconciliations was a contractor and not an employee. We also reported that 32 individuals were performing other functions based upon a

November 2005 staff roster provided by the CFO. We do not believe there are inaccuracies or that they are serious.

Further, contrary to management's assertion, employees performing bank reconciliations should be restricted from access to the accounts they are reviewing to ensure they do not force reconciliations into balance with the accounting records. Separation of duties is needed so that one individual is not in a position to both perpetrate and conceal errors or fraud in the normal course of his or her duties. This is not to say that the same employees should not have access to other non-conflicting areas of the general ledger.

Management believes it has deployed compensating controls where resource constraints have compromised its ability to separate duties. However, we saw limited evidence of compensating controls, such as reviews of detailed transactions initiated by staff or reviews of supporting documents for a sample of transactions, which, in our opinion, would adequately address the lack of segregation of duties. Further, relying solely on compensating controls is less desirable than establishing separation of duties because compensating controls ordinarily occur after transactions are complete. It takes more resources to investigate and correct errors, and recover losses, than it does to prevent them.

Concern over the report's failure to mention OHR's responsibility for reconciling the CIGNA account was not raised by the Comptroller in prior discussions on earlier drafts. The fact that OC staff cleared reconciling items for the CIGNA account because OHR ceased to perform this function also does not negate the need for proper controls over reconciliations of this account.

Finally, we believe the Comptroller did not adequately review bank fees because he simply lacked the information to do so. For example, the Comptroller did not have copies of the bank agreements to show what agreed-upon fees were to be charged the Smithsonian as well as internal activity reports indicating the types of services rendered and the frequency of inquiries being made by the units. As a result, the Comptroller did not know how many times each unit was requesting services or products from the banks to verify that the charges were valid and reasonable. Further, 63 types of fees charged the Institution were not tracked nationally, leaving the Comptroller no benchmarks against which to assess the reasonableness of fees charged the Institution. Many of the bank fee issues were also noted in the October 2004 Mitchell & Titus report on the Institution's cash management practices, which concluded there were opportunities for significant savings in the bank services area.

Management also disagreed that the large volume of fees for information services were a reflection of individual unit inquiries. We believe this statement is inconsistent with actions the OC staff took to reduce unit inquiries. According to the Manager of the Financial Information Processing Division, in early 2005, OC instructed the units to stop making inquiries of the banks. In December 2005, the Comptroller told us he was going to instruct the banks not to accept unit inquiries, and, in January 2006, the Comptroller provided written acknowledgement to us that he "would support an OIG recommendation to cease unauthorized unit activity."

Of the 13 report recommendations, management concurred with 10 and partially concurred with 3. While corrective actions proposed by management were generally responsive to the recommendations, we believe that additional actions are needed on five recommendations before we can consider them fully resolved. Management's response to our recommendations and our evaluation of their planned actions are discussed below.

Separation of Duties

We made five recommendations to address the lack of separation of duties in OC. Management concurred with recommendations 1 and 3, and partially concurred with recommendations 2, 4, and 5. We believe that management's response in some areas reflects a misinterpretation of the control weaknesses underlying the recommendations. In our view, the proposed actions are not fully responsive to any of the five recommendations.

Recommendation 1. The Comptroller agreed to review the separation of duties among his employees and ensure compliance with SD 115 by February 13, 2006. However, he will not restrict general ledger access to accountants involved with the bank reconciliation process. He stated that accountants have other duties in OC requiring general ledger access, and a separation of duties is not warranted given that compensating controls are in place.

We recognize that OC accountants may have other responsibilities requiring general ledger access. We are recommending only that they not be given ledger access to those accounts they are responsible for reconciling. Because OC is planning to hire several more employees in 2006, we believe it could use these resources to reassign duties and functions to address this control weakness.

Further, although management states there are compensating controls to mitigate the lack of separation of duties, the Comptroller did not provide details of these controls to the auditors. We acknowledge that OC now performs monthly bank reconciliations, but bank reconciliations are merely a detective (after-the-fact) control and do not prevent theft of the Institution's assets. Therefore, we are requesting the Comptroller either describe the compensating controls he has implemented to resolve this issue or explain how he plans to use new hires in 2006 to provide the proper separation of duties.

Recommendation 2. The Cash Management Officer will approve all wire transfers before funds are transmitted, but the Comptroller does not agree that transfers in excess of $1 million should be reviewed by higher-level managers. He believes unit approval of these transactions is sufficient.

We believe that the Comptroller may have misunderstood our recommendation. We agree that units budget-checking and approving wire transfers before they are sent to OC for processing will enhance internal controls. However, because OC employees can both execute wire transfers and record them in the accounting system without review by a higher-level supervisor, they can create "fictitious" wire transfers that are not generated by

the units. For example, employees can transfer money to their own accounts or to a fictitious payee and improperly record it as a payment to a valid vendor in the accounting records.

We do not believe that outgoing wires in amounts over $1 million should be entirely under the control of one manager in OC. The risk of loss is high because cash is a liquid asset vulnerable to theft, and cash transfers by wires allow an instantaneous transfer of funds. While it is possible that this type of fraud may eventually be detected, funds could be lost and it would be very difficult to recover them once misappropriated.

Our recommendation is consistent with recent guidance on internal controls and a prior consultant study. According to the October 2005 Treadway Commission exposure draft on internal controls,[10] as dollar thresholds increase, additional approvals from senior levels of management are required. In addition, PricewaterhouseCoopers, in its 2004 report on the Institution's internal controls also recommended that specific limits be established for signing authority on bank transfers.

The Comptroller or his designee should be reviewing wire transfers in excess of $10 million and the Division Manager or her designee should be reviewing transfers over $1 million to reduce the risk of fraudulent transactions. We do not believe this is unduly burdensome because OC staff told us they transmit an average of two wires over $10 million monthly. Due to the high risk of loss in this area, we do not consider the corrective action proposed to be fully responsive to the recommendation.

Recommendation 3. The Comptroller agreed to instruct the Institution's banks to not accept any wire transfers without authorization from the Cash Management Officer. This action is not fully responsive to our recommendation because it does not address higher-level authorizations for bank acceptance of large dollar wire transfers. The Comptroller or his designee should be authorizing wire transfers in excess of $10 million and the Division Manager or her designee should be authorizing transfers over $1 million to reduce the risk of fraudulent transactions.

Recommendation 4. In lieu of implementing the recommendation, the Comptroller proposes strengthening unit authorizations of wire transfers before they are sent to OC for processing. The Comptroller does not believe additional monthly reviews of wire transfers made by OC are necessary because OC only processes wire payments for properly approved transactions. As discussed in our response to recommendation 2, the action proposed by the Comptroller will not mitigate the control weakness we reported as it does not provide a mechanism for detecting whether OC employees have created fraudulent wire transfers or transferred funds to fictitious vendors. A sampling of outgoing wires should not be onerous, and we believe the benefit of this control far outweighs its cost.

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[10] ***Internal Control - Integrated Framework, Guidance for Smaller Public Companies Reporting on Internal Controls over Financial Reporting,*** the Committee of Sponsoring Organizations of the Treadway Commission, October 2005.

Recommendation 5. Instead of reviewing journal entries in excess of $100,000 as recommended, the Comptroller agreed to review a sample of journal entries for proper documentation and support on a quarterly basis as part of his ongoing compliance efforts. He stated there is considerable activity in journal entries at the $100,000 and above level of materiality, and he does not have adequate staff to review those transactions. He also indicated that "OC divisional managers are well informed as to non-routine activities…and are actively engaged in the proper recording of these items."
We do not share the Comptroller's confidence in the proper recording of journal entries because of errors we found during our 2005 audit of bank reconciliations. We reported that $9.4 million or 76 percent of the reconciling items sampled were caused by errors made in data entry and that the majority (90 percent) of these errors were made by OC.[11] Further, PricewaterhouseCoopers, in its report on internal controls, also recommended that all journal entries be reviewed and approved by a supervisor in OC's Financial Analysis and Reporting Division.

We believe that if journal entries were subject to better review and approval, the Institution could more readily implement quarterly financial reporting. If the Comptroller has a reasonable alternative to the $100,000 threshold we proposed, we are open to his suggestions. However, the response provided does not satisfactorily address the recommendation.

System Access Levels

Management concurred with recommendations 6, 7, 8, 9, and 10. OC supervisors will be instructed to review and sign all access forms for OC and the Comptroller will review all changes to OC employee system access. The Comptroller will also formalize and document the annual review of the appropriateness of system access levels granted to OC employees and work with the OCIO to modify access levels, where appropriate. Further, the CFO will assign responsibility for reviewing separation of duties related to the PeopleSoft system access levels between the various CFO departments and provide the financial systems integration manager with adequate information, training and support to allow him to appropriately evaluate system access requests. We believe these proposed actions should resolve the issues underlying the recommendations.

Oversight of Bank Fees

Management concurred with recommendations 11, 12, and 13. The Comptroller will ensure that charges for banking services are valid and reasonable and that future agreements allow for a monthly analysis of fees. He will also direct the Institution's current banking partners to either reject or limit miscellaneous services provided to units and will establish a written policy to document controls put into place as a result of this report. We believe these proposed actions are responsive and should address the issues identified in our report

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[11] ***Audit of Bank Reconciliations,*** Office of the Inspector General, September 28, 2005.

ACTIONS REQUIRED

Because corrective actions proposed for recommendations 1, 2, 3, 4, and 5 will not fully resolve the issues identified, we would appreciate receiving your written plans for resolving these open recommendations within 30 days from the date of this report. You may provide alternative courses of action that you believe would resolve the issues presented in this report.

We appreciate the courtesies and cooperation of Smithsonian representatives during this review. If you have any questions concerning this report, please call me at (202) 275-2154 or Stuart Metzger at (202) 275-2159.

APPENDIX A. OBJECTIVES, SCOPE AND METHODOLOGY

The objectives of our review were to evaluate internal controls in the Office of the Comptroller over separation of duties, access to financial records, and oversight of banking fees. In evaluating controls over cash management and banking activities, we reviewed duties and system access levels for 15 of 55 employee and contractor positions[12] in the accounts payable, cash management, and bank reconciliations groups to determine how employees reviewed, processed, and recorded banking and other financial transactions. We did not attempt to detect fraudulent activity by testing individual transactions where we noted internal control weaknesses. We conducted our review in Washington, D.C. from October 2005 to December 2005 in accordance with ***Government Auditing Standards*** as prescribed by the Comptroller General of the United States.

Separation of Duties in the Office of the Comptroller

In determining whether employee duties were properly separated in OC, we reviewed two studies issued in 2004 and 2005 conducted by PricewaterhouseCoopers, LLP. We also reviewed a 2005 workforce analysis study of financial management resources by Booz Allen Hamilton.[13] We assessed the separation of duties for 15 positions in the Financial Analysis and Reporting Division and the Financial Information Processing Division to determine whether employees could both access assets and accounting records. These positions were responsible for accounts payable, cash management, and bank reconciliations functions within OC. We reviewed accounts payable positions to determine how vendor information could be modified and how payment vouchers were created in the financial system. We reviewed bank reconciliation positions to determine if employees could reconcile accounts and also post entries to the general ledger, which would increase the risk of improper recording of accounting entries.

We also reviewed cash management positions and met with staff in OC's cash management department and the Office of the Treasurer to discuss procedures for transferring money electronically between the United States Treasury, the Institution, and among two of the Institution's bank accounts. In addition, we observed employees as they processed on-line electronic funds transfer requests to the United States Treasury and two banks, noting internal control features and weaknesses.

System Access Levels

To evaluate employee system access capabilities, we obtained a list from OCIO of all OC personnel having PeopleSoft access privileges, and judgmentally sampled 15 employee positions from the accounts payable, cash management, and bank reconciliations groups for analysis of systems access controls. We evaluated whether user access rights were

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[12] The 15 positions included two contractors.

[13] ***Smithsonian Institution Internal Controls Review – Phase II***, PricewaterhouseCoopers LLP, December 2004; ***Security Review and Penetration Testing of Financial Systems***, PricewaterhouseCoopers LLP, April 2005; ***Assessment of Banking Relationships and Cash Management*** Practices, Mitchell & Titus, LLP, October 2004; and ***Focused Workforce Analysis***, Booz Allen Hamilton, September 2005.

appropriate for the 15 positions, and whether the job duties and access rights were consistent with good internal control measures. We verified user access levels through discussions with the OCIO technical staff. We also observed users' financial system access levels in PeopleSoft when they logged onto the system and determined what features were available to them on-line.

Validity of Bank Fees

In assessing the Institution's oversight of bank fees, we reviewed a 2004 study by Mitchell and Titus, LLC, met with consultant representatives, and interviewed OC personnel to discuss OC's policies and practices with respect to bank fees. We also reviewed bank agreements and fee schedules that OC was able to provide us; however, we could not assess the validity of the fees charged the Institution because OC lacked detailed transaction reports, bank agreements, and prior-period fee schedules.

APPENDIX B. MANAGEMENT COMMENTS

Smithsonian Institution

Office of the Chief Financial Officer
Office of the Comptroller

Date January 27, 2006

To Debra Ritt, Inspector General

From Alice C. Maroni, Chief Financial Officer
Andrew J. Zino, Comptroller
Dennis Shaw, Chief Information Officer

Subject Response to Draft Management Advisory Report on Internal Control Weaknesses in Cash Management and Banking Activities, Number M-06-01

Thank you for the opportunity to respond to this management advisory report. We take internal controls very seriously and are always looking for ways to strengthen Smithsonian processes. We regret that this draft of the report continues to reflect inaccuracies despite our efforts to correct the facts as presented earlier in the process.

This management response will address the Inspector General's (IG's) recommendations and also highlight for the record the most serious inaccuracies in the report's narrative as we see it.

The identification of individuals and their duties in the Office of the Comptroller (OC) is not correct as reflected in the IG's report. Six individuals are assigned to the bank reconciliation function, while 31 individuals are assigned to other functions within OC. Additionally, it is critical that the report acknowledge that the individuals who perform the bank reconciliation function within OC are "accountants," and have additional duties beyond bank reconciliation. As such, these individuals require access and the ability to work with the Institution's general ledger to perform the balance of their duties. One of the IG's recommendations on the separation of duties faults OC for allowing these individuals access to the general ledger. Given current staffing limitations and the existence of compensating controls which give the Comptroller confidence in existing processes, these individuals will continue to have general ledger access to perform the balance of their assigned duties.

The IG's Management Advisory states that one OC employee in the bank reconciliation group had both performed the bank reconciliation and cleared reconciling items for the Institution's CIGNA account. The IG failed to state that the only reason that OC personnel performed both of these functions was that the Office of Human Resources (OHR), where responsibility for the preparation of the journal entries for this CIGNA activity rightfully belongs and has traditionally been done, had ceased to perform this function without establishing an alternative. At the direction of the Comptroller, OC personnel temporarily took control of this activity to ensure that the proper accounting

entries for this activity were recorded on a timely basis in the general ledger, preventing a much larger problem had these entries not been made. As was always the plan, this duty has since been returned to OHR, where individuals are now approving all expenses related to the CIGNA account and are again responsible for preparing the related journal entries for this activity.

The IG's Management Advisory also characterizes the process of monitoring bank contracts and fees as weak. The Comptroller does not agree with this generalization. From the early days of his Smithsonian tenure, the Comptroller has taken a personal interest in the monitoring of the banking fees incurred by the Institution. He personally analyzed the banking fees in FY 2004, and provided numerous adjustments to the general ledger to properly record the related activity for that year. The Comptroller also instituted a quarterly analysis of all banking charges and their reconciliation to the appropriate general ledger accounts. The Comptroller, based upon his lengthy and distinguished professional experience as both an auditor and consultant to numerous banks, does not agree with the IG's characterization that OC has paid numerous banking fees "without determining the validity or reasonableness of the fees." After the extensive analysis performed by the Comptroller in 2004 and subsequent reviews of the data, the Comptroller does not agree that the level of bank charges are out of the ordinary for the size or level of banking activities in which the Institution is currently engaged.

The IG's Management Advisory also indicates that "the Smithsonian was charged for inquiry fees based on an activity level of about 17,000 inquires monthly" and uses this assertion to criticize the validity or reasonableness of banking fees. This is an inaccurate description of the charge in question and fails to reflect the Institution's banking reconciliation practices. Specifically, the Institution made a conscious decision to incur this charge to allow the Institution access to review recorded banking information on deposit and other bank activity for the purpose of supporting the bank reconciliation process and answering unit questions with respect to their banking transactions. The Institution incurs this very nominal charge to allow OC personnel access to this information on a real time basis. This charge pays for a specific service that the bank provides the Institution which facilitates the banking processes at the Institution and is not a direct reflection of individual "inquires" as presented by the IG.

The following section will address the specific IG comments as follows:

Recommendations:

We recommend that the Chief Financial Officer (CFO) should:

1. Review functions currently performed within OC and take steps to ensure that employees do not have control over multiple phases of a transaction, consistent with SD 115.

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Response: Concur. OC will undertake a review of all OC employees to ensure compliance with SD 115. However, staffing levels will not permit OC accountants involved with the bank reconciliation process to be precluded from performing other assigned duties within OC which requires access to the Institution's general ledger, nor is this warranted given existing compensating controls in place.

Target completion date: February 13, 2006

2. Require the Cash Management Officer to approve all outgoing wire transfers before funds are transmitted. In addition, require that wire transfers in excess of $1 million be approved by the manager of the Financial Information Processing Division and those over $10 million be approved by the Comptroller, or in their absence by designated alternatives.

   Response: Partially Concur. The Cash Management Officer (CMO) will approve all wire transfers before funds are transmitted. The process will be documented by the CMO and approved by the Comptroller. The Comptroller does not agree that additional reviews are necessary for wires in excess of $1million. Transactions that are submitted to OC for processing and payment are already "approved" transactions which have been budget checked and approved for payment by the submitting entity.

   Target completion date: March 30, 2006

3. Instruct the banks not to accept any wire transfers from the Institution's bank accounts without authorization from the Cash Management Officer, the manager of Financial Information Processing Division, the Comptroller, or in their absence by designated alternatives.

   Response: Concur. OC will instruct the Institution's banks to not accept any wire transfers without authorization from the Cash Management Officer. (See response for item #2 above.)

   Target completion date: January 31, 2006

4. Require monthly review of wire transfers to ensure they are properly supported and approved.

   Response: Partially Concur. OC only processes wire payments for properly approved and supported transactions. OC is not the "initiator" of the underlying transactions. As the Cash Management Officer is responsible for authorizing all wire payments to be made, an "additional" monthly review is not deemed necessary. The Comptroller agrees to formalize instructions to unit financial managers authorizing wire payments making it clear that their authorization of

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wire transfers require the signature of two authorized individuals. The units will be informed that appropriate documentation substantiating the wire transfer must be provided to OC prior to any payments being made.

Target completion date: March 30, 2006

5. Ensure that non-routine journal entries as well as those over $100,000 are reviewed and approved by a supervisor.

Response: Partially Concur. This specific recommendation is not practical given the considerable activity in $100,000 journal entries and the current staffing levels in OC. Staffing levels would have to be significantly increased to perform a review at this level of "materiality." As far as the (undefined) non-routine journal entry review and approval by a supervisor recommendation, it is the Comptroller's belief that this is already being performed. The Comptroller is already personally involved with a significant number of "non-routine" financial activities (i.e. sale of Victor building, the disestablishment of the former Smithsonian Institution Press, recording of major donations activity, real estate purchase/sale transaction). OC Divisional managers are also well informed as to non-routine activities with their respective departments and are actively engaged in the proper recording of these items.

The Comptroller however, agrees to review a sample of journal entries for proper documentation and support, on a quarterly basis, as part of his on-going compliance efforts.

Target completion date: June 30, 2006

6. Require OC supervisors to review and sign system access forms before they are sent to the OC manager for systems integration to ensure that OC employees are granted only the access needed to perform their jobs.

Response: Concur. OC supervisors will be instructed to review and sign all access forms for OC employees before they are sent to the OC manager for systems integration. In addition, the Comptroller will review all changes to OC employee system access.

Target completion date: January 31, 2006

7. Require the systems integration manager to retain approved system access requests, and as required by Smithsonian Directive 301, annually review the appropriateness of system access levels granted OC employees and work with OCIO to modify access levels, where appropriate. Because OC had not provided OCIO a list of needed system access modifications for its employees, OC should do so not later than 30 days from the date of this report.

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Response: Concur. The system integration manger will retain duplicate copies (already maintained by OCIO) of approved system access requests. OC will formalize and document the annual review of the appropriateness of system access levels granted to OC employees. The systems integration manager will also work with OCIO to modify access levels, where appropriate.

Target completion date: February 13, 2006

8. Assign responsibility for reviewing separation of duties related to *PeopleSoft* system access levels between the various CFO departments to ensure that no one individual can control multiple phases of a transaction.

   Response: Concur. The CFO will assign responsibility for reviewing separation of duties related to the *PeopleSoft* system access levels between the various CFO departments to ensure that no one individual can control multiple phases of a transaction.

   Target completion date: March 31, 2006

9. Ensure that the financial systems integration manager is provided adequate information, training, and support from OC and OCIO on *PeopleSoft* system access levels and employee job duties to allow him to appropriately evaluate system access requests.

   Response: Concur. The financial systems integration manager will be provided with adequate information, training, and support from OC and OCIO on *PeopleSoft* system access levels and employee job duties to allow him to appropriately evaluate system access requests.

   Target completion date: June 30, 2006

We recommend the Chief Information Officer:

10. Work with OC to more clearly define system access levels, roles, and permissions for OC staff and revise access forms to better describe the respective financial system access levels.

    Response: Concur. The CIO will work with OC to more clearly define system access levels, roles, and permissions for OC staff and revise access forms to better describe the respective financial system access levels.

    Target completion date: June 30, 2006

We recommend the Chief Financial Officer:

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11. At least quarterly, verify that charges for banking services are valid and reasonable in accordance with the Institution's agreements with the banks. Ensure a provision is incorporated into future banking agreements to allow for a monthly analysis of bank fees.

    Response: Concur. The Comptroller will ensure that charges for banking services are valid and reasonable in accordance with the Institution's agreements with the banks. The Comptroller will also ensure that a provision is incorporated into future banking agreements to allow for a monthly analysis of bank fees.

    Target completion date: June 30, 2006

12. Direct the Institution's current banking partners to either reject or limit miscellaneous services provided to the units, until new banking arrangements are established.

    Response: Concur. The Comptroller will direct the Institution's current banking partners to either reject or limit miscellaneous services provided to the units.

    Target completion date: February 28, 2006

13. Formalize the controls recommended to OC in this report into written policy to ensure current and future OC employees have appropriate operating guidance and to better document controls over cash management and other financial management activities.

    Response: Concur. The Comptroller will direct the Division Manager of the Financial Policy and Procedures Division within OC to develop all written policies and procedures to document any changes to such policies and procedures relative to this report.

    Target completion date: June 30, 2006