U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

AUDIT OF THE INTERNAL CONTROL STRUCTURE

OF THE DEPARTMENT OF ENERGY'S

WORKING CAPITAL FUND

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OFFICE OF AUDIT SERVICES

AUDIT OF THE INTERNAL CONTROL STRUCTURE OF THE DEPARTMENT OF ENERGY'S WORKING CAPITAL FUND

Audit Report Number: CR-B-98-01

SUMMARY

The Subcommittee on Energy and Water Development of the Committee on Appropriations, in its report dated July 16, 1996, approved the implementation of a Working Capital Fund (Fund) at the U.S. Department of Energy. The Subcommittee also directed the Office of Inspector General to conduct periodic audits of the Fund. This audit was conducted to determine if the Department established an effective system of controls over the Fund. Our specific objectives were to determine if internal controls were sufficient to ensure that appropriate costs were allocated in a reasonable and unbiased manner and in a way that was consistent with the expectations established by the Congress.

The Department completed a significant amount of work in a relatively short period of time to implement the Working Capital Fund. Additionally, the Fund may already be realizing benefits by making administrative costs more visible to program offices. However, Fund management needs to strengthen controls in the following areas. First, policies and procedures should be implemented to periodically compare actual costs to estimates used as a basis for customer billings. The Fund also needs to establish formal policies and operating procedures addressing funding excesses and shortages, and management roles, responsibilities, and authorities. Additionally, the contract audits pricing policy needs a simpler cost allocation process that facilitates the verification of customer billings. Finally, the Department needs information on the full cost of Fund services in order to make management decisions.

Management generally concurred with the findings and recommendations and is planning corrective actions.

/s/
Office of Inspector General

PART I

APPROACH AND OVERVIEW

INTRODUCTION

The Subcommittee on Energy and Water Development of the Committee on Appropriations, in its report dated July 16, 1996, approved the implementation of a Working Capital Fund (Fund) at the U.S. Department of Energy. The Subcommittee also directed the Office of Inspector General to conduct periodic audits of the Fund. This audit was conducted to determine if the Department established an effective system of controls over the Fund. Our specific objectives were to determine if internal controls were sufficient to ensure that appropriate costs were allocated in a reasonable and unbiased manner and in a way that was consistent with the expectations established by the Congress.

SCOPE AND METHODOLOGY

We conducted fieldwork from March through June 1997 at Department of Energy Headquarters' offices in Washington, DC and Germantown, MD. Fieldwork consisted of meetings with officials in the Office of Human Resources and Administration and the Office of Chief Financial Officer as well as with officials from the various Departmental program offices. We discussed cost allocation and pricing policies, funds control procedures, business line activities, and relevant operational guidelines with officials responsible for managing Fund activities and separate business lines. Fieldwork also included meetings with the program offices to determine how they controlled funds and managed costs and to discuss positive and negative aspects of the operation of the Fund. Finally, based on an analysis of costs and business line complexity, we selected three business lines and performed a detailed analysis of Fiscal Year 1997 obligations, costs, and customer billings.

The audit was performed in accordance with generally accepted Government auditing standards for performance audits and included tests of internal controls and compliance with laws and regulations to the extent necessary to satisfy the audit objectives. Our assessment of the significant internal controls consisted of reviews of pricing and financial related policies and general operating policies and procedures as well as tests of billing controls. Because our review was limited, it would not necessarily have disclosed all internal control deficiencies that may have existed at the time of our audit. Although computer-processed data were not significant to the findings, we included tests to trace data from the Fund's billing system to supporting documentation and found no discrepancies.

BACKGROUND

The Department established the Fund in January 1996 as a financial management tool for charging the costs of common services provided in the Headquarters' area back to Departmental program offices using those services. Prior to the Fund, the Office of Human Resources and Administration paid for the cost of these services from the Departmental Administration account without attempting to allocate the costs back to the programs using the services. Currently, Departmental program offices make annual, quarterly, and monthly payments into the Fund from their program direction accounts and these offices are charged for the services they consume. The Department's objectives, in establishing the Fund, were to allocate the full costs of the services to the program offices, improve efficiency and reduce costs, and create a market-like framework for obtaining the services. In Fiscal Year 1997, the cost of all services administered by the Fund was expected to total about $93 million.

The Department divided responsibilities for managing Fund activities between the Working Capital Fund Board, the Fund Manager, Departmental program offices or "customers," and business line managers. The Board established policies and designated activities to be included in the Fund and working groups to deal with technical issues related to policy decisions. The Fund Manager and staff provided advice to the Board, reviewed proposed policies and procedures for compliance with Departmental guidelines, directed formulation and monitored execution of Fund budgets, and provided explanations of Fund activities. Program customers were expected to participate in the budget formulation process and control the level of the services they used. Business line managers were expected to monitor and control the costs of services provided under their business lines.

In Fiscal Year 1997, the Fund consisted of 3 different areas and 10 business lines. The "Administrative Services" area included five business lines: Building Occupancy, Printing and Graphics, Copying, Postage, and Supplies. The "Information Management" area included the Telephones, Networking, and Desktop Support Business Lines. The "Procurement" area included the Contract Audits and Contract Closeout Business Lines. Our review included one business line from each area--Building Occupancy, Telephones, and Contract Audits. These three business lines comprised about 79 percent of the total anticipated cost of the Fund.

In granting approval for the Department to implement the Fund, the Congress set certain requirements. The Subcommittee on Energy and Water Development Report indicated that the Congress looked for the Department to establish management processes and policies to ensure that advance payments are minimized, the Fund is not used to maintain unencumbered funds, and pricing and allocations to customers are sound and defensible. The Congress also directed that Federal salaries and employee related expenses not be charged to the Fund and favored broad-based customer representation on the Board.

OBSERVATIONS AND CONCLUSIONS

Between January and October 1996, the Department completed a significant amount of work to implement the Fund. This effort included establishing the Board; drafting its charter; providing an overview of the Fund to the Office of Management and Budget and the Congress; establishing working groups to develop pricing policy options for each business line; and holding numerous Board meetings to finalize pricing policies. In addition, meetings with officials from other agencies were held to gain an understanding of how other working capital funds were operated.

During Fiscal Year 1997, the first year of operation, the Department reported that costs for the Fund were expected to total about $3 million less than the original $93 million estimate. This anticipated reduction may be attributed to the fact that costs are more visible under the Fund concept and some customers are better managing their use of Fund services. Additionally, efforts by business line officials may be contributing to cost reductions. For example, Telephone Business Line officials initiated action to obtain approval for a fixed-rate structure from a local telephone company. The new structure, which is currently being reviewed by the Federal Communications Commission, could produce notable savings. In addition, Fund management and business line officials used a self-assessment process to evaluate their efficiencies and progress in meeting goals and customers' needs.

Notwithstanding these accomplishments, and as noted in Part II of this report, certain policies and procedures needed to be strengthened to ensure that the Fund appropriately allocates costs and meets congressional expectations. Specifically, the following conditions require management attention:

◊ Actual costs and obligations for the three business lines reviewed were lower than amounts billed customers. These differences and data inaccuracies and miscalculations resulted in the Fund collecting more than was necessary.

◊ The Department had not prepared formal operating procedures defining roles and responsibilities for managing costs and budget estimates and had not adequately addressed the disposition of fund excesses and shortages. As a result, program offices were not fully aware of their responsibilities for controlling costs and funds.

◊ The pricing policy for the Contract Audits Business Line was exceedingly complex and subjective. As a result, it was unclear whether billings were reasonable or customers were treated equitably.

◊ The Department had not collected information on the full cost of Fund services. As a result, the Department could not determine the economic viability of the provided services.

Our limited review did not disclose any material internal control deficiencies. However, we made recommendations to improve controls in each of the above areas as documented in the remainder of this report. Management generally concurred and is planning corrective action.

PART II

RESULTS OF AUDIT

Controls could be strengthened in four areas. The first finding, Comparison of Actual Costs and Obligations to Billing Estimates, deals with policies and procedures that should be implemented to provide customers with information on the amount of excess payments made or shortages sustained during the fiscal year. The next finding, Formal Policies and Operating Procedures, deals with steps that can strengthen written policies and procedures addressing management roles, responsibilities, and authorities. The third finding, Contract Audits Pricing Policy, discusses the need to improve the basis for allocating contract audit costs among program offices. Finally, Full Cost Identification addresses the need for the Department to consider the full cost of Fund services in management decisions.

Finding 1: Comparison of Actual Costs and Obligations to Billing Estimates

The Subcommittee on Energy and Water Development Report stated that advance payments should be minimal, sufficient to cover outstanding commitments and other reasonable activities and that pricing policies should be sound. Advances to the Fund were made at the beginning of the fiscal year from customers' appropriations and were based on estimates made in the preceding year. As the year progressed, the Department billed customers amounts that, under some pricing policies, were based on these original estimates as opposed to actual costs. These billings reduced the amount of customer advances outstanding. An examination of three business lines disclosed that actual costs and obligations were lower than the amounts billed customers. These differences plus additional data inaccuracies and miscalculations resulted in the Fund collecting more than was necessary. For example:

◊ Under the Contract Audits Business Line, customers were charged the full amount expected to be incurred during Fiscal Year 1997 for outside audit service costs, or approximately $9.8 million. A review of actual costs incurred through May 1997 indicated that costs for the year would total about $800,000 less than the amount originally estimated. In commenting on an earlier version of this finding, Fund management stated that the Board agreed to offer credits to all customers under the Contract Audits Business Line that will reduce the total net charges to approximately $9.1 million.

◊ Under the Telephones Business Line, charges included usage costs for services such as long distance calls and infrastructure charges for such things as telephone lines and circuits. An interim review of the business line indicated that infrastructure costs and obligations for Fiscal Year 1997 would total about $360,000 less than the $5,030,000 originally estimated. Additionally, because of miscalculations, customers were billed more than the amount originally estimated. Each month, the Department allocated the original estimate to customers based on counts of telephone lines that, in April 1997, equated to about $30 per telephone line. However, miscalculations of telephone line "inventories" resulted in customer charges of $33 per line. These miscalculations inflated customer charges since the beginning of the fiscal year.

Fund management agreed that a methodological error was made in computing telephone line rates. The Information Management Operations Group plans to re-compute all telephone and networking bills from the beginning of the fiscal year for both infrastructure and usage and adjust customer bills as necessary. On the other hand, management believes its original $5,030,000 estimate of Fiscal Year 1997 telephone infrastructure costs should continue to be used as the basis for Fiscal Year 1997 pricing. Rather than try to adjust customer charges in response to cost and obligation differences during the year, management's recommended approach is to review costs at the beginning and end of the fiscal year and make adjustments at that point.

◊ Under the Building Occupancy Business Line, customers were charged quarterly an amount expected to cover General Services Administration rent costs plus obligations for operating and maintenance service contracts. A review of cost and obligation data as of April 1997 from an internal financial management system indicated that costs and obligations for the year would total about $750,000 less than the amount originally estimated. Additionally, purchase order and invoice documentation indicated that the obligation data in the financial management system may be overstated. We reviewed a random sample of 29 obligations and found that the sample was overstated by about 13 percent. Projecting this overstatement to the population of obligations could lead to an even larger difference between amounts charged to customers and the sum of actual rental costs plus obligations.

Despite these indications of excessive payments, the Department did not adopt procedures to calculate the potential overages or adjust customer billings. These procedures are important in light of recent developments affecting the Fund. In April 1997, the Department reported that delays in vacating office space would cause the original Building Occupancy estimate to be short by about $725,000. The Department proposed increasing all customer charges to cover the expected shortage. By calculating potential overages in each business line and adjusting customer billings, the Department may be able to lessen the burden on customers attempting to cover potential shortfalls.

Fund management stated that the rent adjustments adopted by the Board were prudent and indicated that it had performed an up-to-date analysis that included a revised projection of anticipated rent costs and contractual obligations, as well as contingency reserves for unplanned expenses. The Department also stated that the summer season frequently involves mechanical failures and high utility bills. Management believed that operating with a 5-percent contingency in the operating and maintenance service accounts (estimated to total about $15 million) to pay for such unexpected events appeared reasonable and concluded that the projected $750,000 excess was acceptable. The Department did agree that an obligation recorded in its internal management system was overstated and stated that it had reconciled the data in the system to the actual contract document.

Recommendation:

The Board should adopt a policy to have each business line manager periodically compare actual costs and contractual obligations to the estimates used as the basis for customer billings. This review should include steps to ensure the accuracy of the data, and the results should be presented to the Board so that it can determine whether differences should be reflected in subsequent customer billings.

Management Comments. The Chairman concurred with the recommendation, subject to the need to avoid significant costs for new information systems. The Board will review informal management systems used by business line managers to ascertain whether and how it can improve the timeliness and reliability of these systems' forecasts of costs without a major expenditure of funds. The Chairman also identified the following actions to address our recommendations.

- The Board agreed to permit the Fund Manager to reduce prices when it appeared that costs were underrunning original estimates. However, pricing policy changes to increase prices, to accommodate projected cost increases, would continue to require Board action.

- Fund Management will draft a procedure to continue quarterly reviews initiated during Fiscal Year 1997 including the definition of the types of financial information the Board would receive.

Auditor Comments. Management actions are responsive to our recommendation.

Finding 2: Formal Policies and Operating Procedures

The Fund represented a new way of managing administrative services for the Department. Thus, as indicated above, it was important that policies and procedures be established to facilitate this change and ensure that the Fund operated in an efficient manner. In addition, the Congress stipulated that a policy on excess advances was necessary and that the Fund should not be managed in a way that would produce a profit or allow unencumbered funds to be maintained. Policies and procedures were necessary to ensure that these expectations were met. However, the Department lacked formal operating procedures for managing the Fund and policies to adequately address the disposition of excesses and shortages of funds.

The Department did not have formal operating procedures defining roles and responsibilities for managing costs and budget estimates. Discussions with affected program offices showed that many were not fully aware of their new role as Fund customers. For example, some program offices believed it was Fund management's responsibility to control costs and prevent them from overobligating funds. Additionally, some program officials relied on Fund management to provide budget estimates and did not participate in the budget formulation process by providing feedback on the types and levels of services they expected to consume during the year.

Additionally, the Board had not adequately addressed the disposition of excesses and shortages of funds. As indicated above, the Fund billed customers based on cost estimates. These estimates could lead to a customer paying too much under one business line and too little under another. Since the original customer appropriation did not restrict funding to each business line, customers can adjust funding between business lines to cover projected shortages. In addition, the Department analyzed its uncosted balances on prior year contracts related to Fund activities and planned to transfer a portion of these balances into the Fund in excess of customer payments. However, there was no written policy to address the use of the uncosted balances transferred into the Fund or an acceptable level of carryover to the next fiscal year. Similarly, there was no written policy on the disposition of excess funds or shortages or the use of business line excess funding to cover other business line shortages.

Recommendation:

The Fund Manager should:

1. In cooperation with the Office of Chief Financial Officer, write formal operating procedures defining the relative roles, responsibilities, and authorities of Fund managers and program customers in controlling costs, preventing obligations that exceed authorized amounts, and reviewing budget estimates for accuracy and reasonableness.

2. Establish a policy to address the disposition of excess funds and shortages, the use of business line excess funding to cover other business line shortages, the use of uncosted balances transferred into the Fund, and an acceptable level of carryover to the next fiscal year that is consistent with the expectations of the Subcommittee on Energy and Water Development.

Management Comments. The Chairman concurred with the finding and identified the following corrective actions in response to our recommendations. The Chairman stated that Fund management is committed to the improvement and issuance of formal documentation of the Fund's policies and procedures. He noted that the Board recently adopted formal policies for the administrative control of funds and for the accounting for assets and liabilities. Formal policies on pricing procedures and accounting are being prepared by the Office of Chief Financial Officer. The Fund Manager has developed a plan for issuance of a consolidated manual containing relevant Fund documentation in conjunction with a Office of Chief Financial Officer initiative to teach program officials methods for administering program direction budgets.

Auditor Comments. Management's actions are responsive to our recommendations.

Finding 3: Contract Audits Pricing Policy

The Subcommittee on Energy and Water Development Report stated that pricing policies should be sound and defensible. We view this to mean that they be fair with a reasonable basis for the allocation. However, the allocation basis for the Contract Audits Business Line was exceedingly complex and subjective. As a consequence, it was unclear whether customer billings were fair and reasonable.

The contract audits pricing policy used prior years' audit billings to estimate current year costs. For the most part, these bills charged for audit services at a given field location but were not tied to the various program offices at the location. Thus, allocating these audit costs and billing program customers often required a subjective analysis. In addition, the official involved in the allocation process stated it was resource intensive, requiring a review of several hundred contracts and the preparation of extensive spreadsheets. In Fiscal Year 1997, this process required a review of over 1,500 contracts. We also noted that the Department's basis for allocating these costs among customers was not adequately documented. Accordingly, we were not able to validate the propriety of customer billings.

Despite this lengthy process, the resulting allocation of audit costs did not satisfy the Fund's customers. Many customers felt that their bills were unclear and were frustrated in their attempts to relate the amounts billed to current year activity. Others felt that the allocations were not equitable and the business line should be removed from the Fund.

Recommendation:

The Board should consider a simpler allocation process for billing contract audit services that facilitates the verification of customer billings.

Auditor's Note: After the end of our audit fieldwork, we received the report of the Energy and Water Development Subcommittee, which stated that contract audit costs should not be included in the Fund for Fiscal Year 1998. Instead, these costs should be charged directly to program budgets. Although removing the business line from the Fund would remove the issue as it relates to the Fund, it would not eliminate the need for a simpler allocation process.

Management Comments. The Chairman concurred with the finding. The Board, at its August 12, 1997, meeting, voted to remove the Contract Audit Business Line from the Fund for Fiscal Year 1998. The Chairman also stated that the Human Resources and Administration and the Office of Chief Financial Officer are working together to implement a simplified process for financing these audits in Fiscal Year 1998.

Auditor Comments. Management's actions are responsive to our recommendations.

Finding 4: Full Cost Identification

Statement of Federal Financial Accounting Standards Number 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," encourages Federal entities to use full cost information in making economic decisions on whether to continue providing a product or service. In the case of the Working Capital Fund, Congress specifically prohibited the Department from charging the costs of Federal salaries and related expenses of employees to the Fund. However, the Department still incurred these costs, and the expenses affected the total cost of providing services. These costs included the costs of Office of Human Resources and Administration staff assigned to manage and operate the Fund and its business lines as well as the costs of facilities, telecommunications, ADP support, and other indirect costs associated with these employees. In addition, program customers assigned personnel to manage the services obtained through the Fund, attend Board meetings, and participate in working groups. Without a mechanism to identify the unreimbursed costs, the Board had no baseline to identify the most efficient practices, nor could it make informed decisions on whether services provided by the Fund were competitive with the private sector.

Recommendation:

Fund management should identify all direct and indirect costs associated with the operation and administration of the Fund and provide the Board with information on these costs.

Management Comments. The Chairman, citing congressional opposition to including Federal salaries and related expenses in the Fund and the Board's priority on reducing the costs of Fund activities, stated that the Fund is reluctant to undertake cost accounting activities not connected to Fund pricing policies if such activity either diverted attention away from efficiency improvements or required significant expenditure of funds. However, he also stated that, based on Board discussion, the Fund plans to continue to collect, analyze, and periodically display information on the major cost elements (primarily direct Federal salaries and space) not now included in the pricing structures. The Board will be advised at least once annually of the implications of such costs for the viability of the various business lines. The Chairman noted, however, that no decisionmaking purpose would be served by collecting detailed information on such indirect costs as attendance at Board and Working Group meetings. It is possible that some very general estimates could be developed on further indirect costs, and over the coming year, the Fund will collect information about the practices of Working Capital Fund managers in other Federal agencies on this matter. At this point, the Board is not willing to commit to specific actions to include further cost information.

Auditor Comments. Although the Congress stipulated that no salaries or other expenses of Federal employees could be charged to the Fund, this information is important in determining the viability of Fund activities. If, in the future, the Congress allows full costs to be charged to the Fund, it could lead to increased business line prices that are not competitive with suppliers outside the Department. Therefore, if full cost information shows that Fund activities are not viable, this information should be known to the Department as soon as possible. In making our recommendation to identify all direct and indirect costs of the Fund, we do not envision an elaborate cost system. For example, the Board could develop an informal process to estimate the extent to which all costs affect each business line. The basis for such estimates should be adequately documented.

Accordingly, we believe that management's planned actions to "collect, analyze, and periodically display information on major cost elements...not now included in the pricing structures" is responsive to our recommendation. Furthermore, as suggested by the Chairman in his comments, general estimates of indirect costs can be developed. These estimates can be used to fully assess the viability of Fund activities.

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