GOVERNMENT-WIDE FINANCIAL MANAGEMENT SERVICES:

Additional Control and Oversight Needed to Reduce Costs and Improve the Plastic Card Network

OIG-03-088 **July 11, 2003**

Office of Inspector General

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The Department of the Treasury

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Abbreviations

ATD	Applied Technology Division
BAMRS	Bank of America Merchant Services System
BOA	Bank of America
ETD	Emerging Technology Division

Contents

EBSD	Electronic Banking Services Division
FMS	Financial Management Service
Mellon	Mellon Bank
OMB	Office of Management and Budget
PCN	Plastic Card Network
TGA	Treasury General Account

July 11, 2003

Richard L. Gregg
Commissioner
Financial Management Service

The Financial Management Service (FMS) implemented the Plastic Card Network (PCN) in 1987 to expedite the collection and deposit of revenues from Federal agencies' credit and debit card sales. Any Federal agency that accepts such cards in the sale of goods and services to the public can elect to join the PCN. FMS utilizes the services of two financial agents—Bank of America (BOA) and Mellon Bank (Mellon)—to conduct the daily operations of the PCN. The FMS reimburses the two financial agents for PCN operating costs through compensating balances deposited with these institutions.

We completed an audit to determine how effectively the FMS has (1) monitored the performance of the PCN financial agents and their subcontractors and (2) controlled PCN costs. We interviewed FMS personnel and reviewed FMS' records related to the PCN and the use of compensating balances to acquire banking services; interviewed representatives of other Federal agencies, as well as corporate officers of entities that manage networks similar to the PCN; and obtained feedback on PCN performance from member agencies. Our audit generally covered the period January 1998 through December 2001. Our objectives, scope, and methodology are discussed in more detail in Appendix 1.

Results in Brief

We found that more effective payment options need to be considered for reimbursing financial agents for PCN operating expenses. FMS needs to evaluate alternative methods of payment and reassess the current earnings credit rate used on the $2.8 billion of compensating balances established to pay for PCN costs. Our analysis found that the policy of using the current rate has caused the Treasury Department to forego approximately $42.2 million over the first 4 years of the PCN agreements with the financial agents. In addition, our review showed that, if current policies and practices continue, the government will pay $797 million in future PCN costs and accordingly will have to increase the level of compensating balances to $5.3 billion by the end of 2007, the final year of the PCN agreement.

FMS had also not established complete and effective management controls over its administration of the PCN. Control weaknesses included inadequate controls over such critical functions as reviewing financial agents' billing statements; recording PCN cost data; calculating FMS earnings on compensating balances; and making payments to financial agents. Because of these control weaknesses, FMS had less assurance that over $124 million of payments to financial agents were proper and/or accurate.

In addition, we found that computer security reviews of PCN systems operating at the financial agents' and their subcontractors' sites were not performed, and that such systems continued to function without the required recertification. Neither FMS nor the financial agents had standard operating procedures in place to ensure that such reviews were performed and in a timely fashion. As a result, FMS is unable to determine that PCN system safeguards remain sufficient to counter threats and vulnerabilities.

We surveyed the six top dollar agencies and asked them about their relationships with the FMS. They stated that the FMS has responded to their questions and complaints effectively and timely, and generally gave the FMS high marks for customer service.

Our report contains recommendations that provide options that will more effectively reduce the cost of operating the PCN and improve the program's management and information technology controls. FMS management concurred with our recommendations and their written response provided the status of their actions to date. FMS is continuing its analysis of the recommendations and plans to develop a detailed corrective action plan. The complete text of FMS management's response is provided as Appendix 4.

Background

FMS instituted a number of projects to assist Federal agencies in expediting collections associated with electronic commerce transactions. One of these projects is the PCN. The PCN was started in 1987. Its objective is to expedite the collection and depositing of revenues resulting from agencies' credit and debit card sales. Any Federal agency that accepts such cards for the sale of goods and services to the public can elect to join the PCN. However, agencies are not required to join and use the PCN. For example, the United States Postal Service and the Smithsonian Institution manage and operate their own plastic card networks and pay for the related operating expenses.

The FMS utilizes the services of two financial agents to conduct the daily operations of the PCN. The financial agents, in turn, subcontract segments of the PCN operations to companies that specialize in specific phases of the plastic card network cycle, such as transaction authorization and processing. In 1987, FMS selected BOA and Mellon as the financial agents for the PCN. In 1998, FMS again awarded the financial agency contracts for the PCN to BOA and Mellon.

FMS reimburses the two financial agents through compensating balances deposited with these institutions. Compensating balances (also known as time balances) are non-appropriated funds deposited with banks and other financial institutions as compensation for banking services. The financial institutions obtain compensation for the services they perform from the earning value generated by the deposited funds. The amount of the compensating balance is determined by matching the earning value of the compensating balance with the cost of the services that are performed by the depositary.

An interest credit is imputed monthly to the holders of the funds using an earnings credit rate that is based on the 3-month Treasury bill rate. The compensating balance levels are then adjusted by the net result of comparing the imputed interest amount to the cost of PCN operations as billed by each of the two financial agents.

PCN collections have been dramatically increasing over the years. Collections have increased from $731 million in 1998, to $1.6 billion in 1999, to $2.2 billion in 2000, and to $3.0 billion in 2001. PCN operating expenses have increased proportionally. Because of this increased expense, coupled with decreases in interest rates, the calendar year-end PCN compensating balances have steadily increased from $330 million in 1998 to a total of $2.8 billion in 2001.

The financial agent agreements establish and define the relationship between the FMS and the banking institutions. As part of the transaction processing terms, both financial agents provide the FMS with monthly invoices that detail PCN fees and charges.

The financial agent agreements also identify certain information security requirements, which the financial agents addressed when they submitted their technical responses. It requires that the financial agents be familiar and comply with the Computer Security Act of 1987 (Public Law 100-235) and all applicable standards and regulations established thereunder.

Findings and Recommendations

Finding 1 More Effective Payment Options Need To Be Considered For Reimbursing Financial Agents For PCN Operating Expenses

FMS has paid for the cost of the PCN by using a static imputed interest rate that is calculated on compensating balances held by the financial agents. FMS and the Treasury Department have a long-standing practice of using the interest rate on 3-month Treasury securities to impute interest on compensating balances. Although this rate may have been appropriate when initially instituted, it was not the most cost effective payment method for the Treasury Department. FMS has recently conducted a study to review its use of the traditional credit rate and terms of compensating balances and has concluded the rate needs to be changed. However, our analysis of historical trends of various securities' rates, PCN operating expenses, and compensating balance levels show other options need to be considered in selecting a payment arrangement that is more cost effective for the Treasury Department. Under the current business practice, FMS deposited up to $2.8 billion in compensating balances that have earned below market rate of return. This lower yield has ultimately caused the government to forego approximately $10.8 million to $42.2 million in interest, depending on the security, over the first 4 years of the agreements with the financial agents (1998 – 2001).

In addition, FMS has incurred $124.5 million in PCN operating costs that could have optionally been absorbed by PCN member agencies or their customers if alternative payment scenarios had been chosen. Furthermore, because PCN costs are not paid with appropriated funds, the Congress and the Office of Management and Budget (OMB) have little, or no scrutiny over projects financed using imputed interest on compensating balances.

If our report's recommendations are implemented, the $2.8 billion in compensating balances could be returned to the Treasury general fund and made available for other uses.

Analysis of the Current Policy and Practice to Use Compensating Balances for Acquiring PCN Banking Services

Since 1942, the Treasury Department has used the imputed interest on compensating balances to obtain certain banking services. FMS has paid for the cost of the PCN using imputed interest calculated on compensating balances on deposit with financial agents which totaled $2.8 billion as of calendar year-end 2001. Although this decision might have been the best course of action at the time the agreements were reached, we believe the financial impact of the continued practice must be reassessed from a cost-benefit standpoint. For the past 40 years, Treasury has followed a practice that the earnings credit rate on all compensating balances is the rate earned on 3-month Treasury bills. This rate applies regardless of the length of time funds are held on deposit with the financial agents. Interest rates for Treasury securities (and corporate securities) generally increase as the term to maturity lengthens. That is, the 3-month rate is typically less than the 6-month rate, which in turn is less than the 12-month rate. On the other hand, the financial agents can invest these compensating balances in any instrument they feel is appropriate but must pledge acceptable collateral as determined by the Bureau of the Public Debt to secure the funds in Treasury's account. The types of securities that financial agents can invest in can provide them a much higher yield than 3-month Treasury bills.

A September 2001 FMS report entitled Report on Expected Term of Treasury Time Balances presented the results of its review of the average time that Treasury time (or compensating) balances remain on deposit with financial institutions. The principal finding of the report suggested that the current basis for the earnings credit rate was not accurate. It concluded that the Treasury should receive a rate on its compensating balances equal to a 6-month, but no higher than a 12-month rate. We discussed the report findings with FMS officials who stated that the policy of using the 3-month Treasury bill rate was fair because the time balances held by the financial agents are callable with little or no notice, although a 14-day notice is often provided. FMS based this conclusion on the assumption that, when the time balances are called, the financial agents sell their related investment portfolios to raise the cash needed to return to the United States Treasury. However, FMS could not provide any written analysis that supported this assumption.

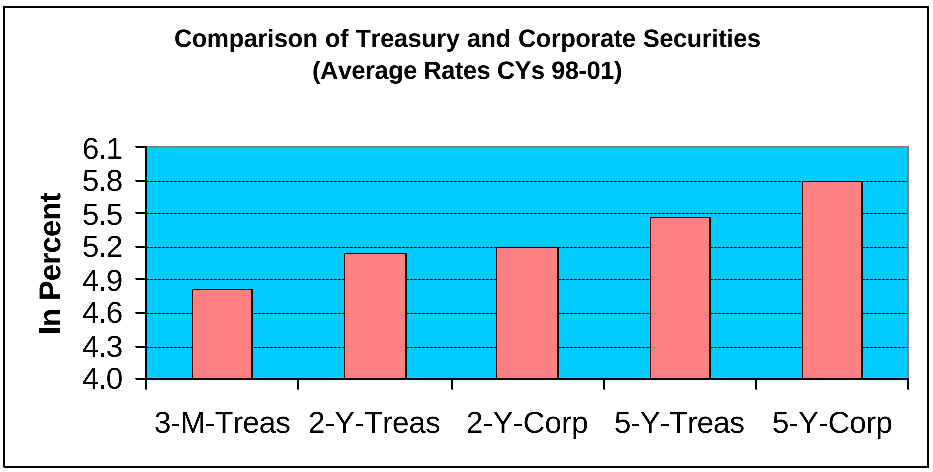
This assumption may not be entirely valid. We asked representatives from both BOA and Mellon about actions they took to raise cash when Treasury called their time balances. They stated that they either used their own cash, if available, or borrowed from another bank at the Federal funds rate, which is slightly higher than the 3-month Treasury bill. It is a rate banks charge each other for overnight loans and is set by the Federal Reserve. Since the inception of the PCN, calls were infrequent and lasted from 1 day to 8 days. When the call ended, time balances were returned to the financial agents. Regardless of whether time balances are called, financial agents will ultimately receive full compensation for services they provided to operate the PCN.

The PCN agreements with the two financial agents is for 5 years and is renewable by an additional five 1-year options. Accordingly, these contractual agreements could conceivably extend to 10 years (1998-2007). Under that scenario, the two financial agents would continue to hold the related compensating balances for as long as the agreements are in effect.

Although the FMS Report on Expected Term of Treasury Time Balances recommended an increase of the earnings credit rate to a 6- or 12-month rate, we believe these rates do not provide the Treasury with a fair rate of return because of the length of time these agreements are in effect.

To illustrate the variation between what Treasury is presently earning; what it could earn with different securities instruments; and what the financial agents could be potentially earning on compensating balances, see Graph 1 for the average earning rates, spanning calendar years 1998-2001, for the 3-month Treasury security, as well as the 2-year and 5-year Treasury and corporate securities.

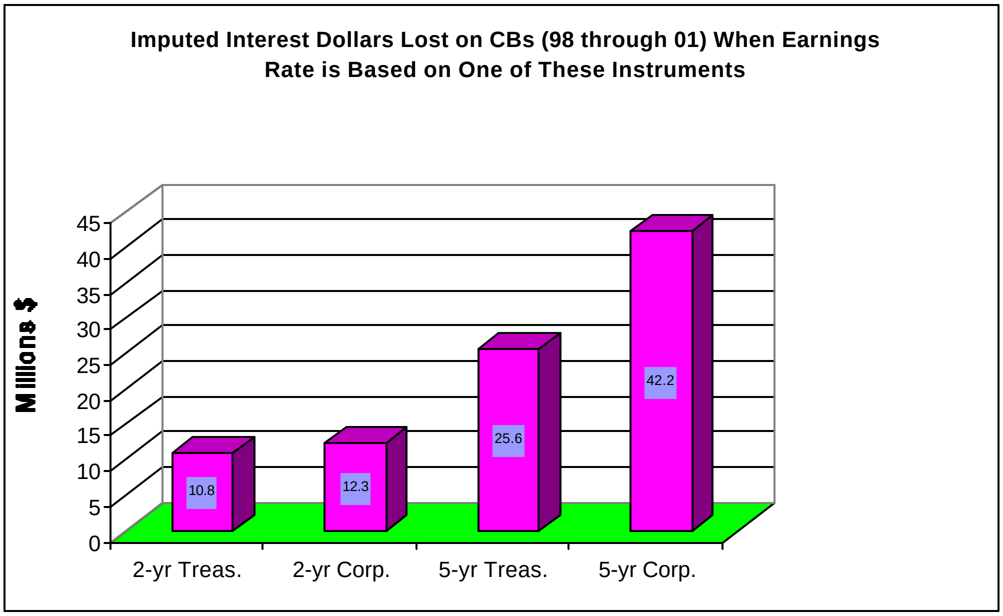
Graph 1



It should be noted that the Federal Reserve Bank of St. Louis ensures that securities pledged are compliant with the list of acceptable securities established by the Bureau of the Public Debt.

We further analyzed what these rate variations meant to the Treasury in lost interest earnings on its PCN compensating balances during the 4-year period January 1998 through December 2001. We calculated the amount FMS could have earned versus the 3-month Treasury bill rate. For example, Graph 2 shows the Treasury could have earned $42.2 million more, over the first 4-year phase of the contract, if interest was imputed based on the 5-year corporate security.

Graph 2



OMB Circular A-123, *Management Accountability and Control*, states, "The proper stewardship of Federal resources is a fundamental responsibility of agency managers. Federal employees must ensure that government resources are used efficiently and effectively to achieve intended program results. Resources must be used consistent with agency mission, in compliance with law and regulations, and with minimal potential for waste, fraud and mismanagement." It further states, "… agencies and individual Federal managers must take systematic and proactive measures to develop and implement appropriate cost effective management controls."

Other Options For Reimbursing Financial Agents For PCN Operating Expenses

In an April 1985 report entitled *Improvements Needed in Controlling and Accounting for Treasury Banking Arrangements*, the U.S. General Accounting Office stated:

> *"Using these balances rather than appropriations reduces the visibility of banking costs, avoids the Congressional oversight through the appropriation process, and reduces the incentive for minimizing costs. Further, FMS has not adequately monitored banking costs and some banks may be over or underpaid as a result"*.

During our audit, FMS personnel stated that paying for PCN operating expenses via compensating balances allows PCN operations to function year-to-year without interruption. FMS staff expressed concern that if such expenses were financed with annually appropriated funds, the PCN operations and, therefore, banking services, may be interrupted if Congress did not timely pass the annual appropriations legislation by the beginning of the fiscal year.

Additional information we obtained provides reasons the FMS should consider alternative payment methods for operating the PCN. First, we surveyed five publicly held corporations in various fields of business that accept credit cards for the sale of their goods and services. All paid for these operational expenses on a service fee basis. Second, we contacted two non-PCN member Federal agencies that accept credit cards for their sales - the United States Postal Service and the Smithsonian Institution. Likewise, they pay for their plastic card operational expenses on a service fee basis. To put it in another context, the combined plastic card sales of the United States Postal Service and the Smithsonian Institution were $4.1 billion, or 137 percent of total 2001 PCN sales of $3.0 billion. If they decided to join the PCN, the current compensating balances would have to increase proportionately by $3.8 billion to a total of $6.6 billion.

The use of domestic banks for depositing agencies' collections and paying for their services through compensating balances is a long standing practice by the Treasury Department. In 1983, there were approximately 700 of these Treasury General Accounts (TGAs) with 500 domestic banks. On May 2, 1983, The Financial Management Task Force of the President's Private Sector Survey on Cost Control issued a report on its assessment of the TGAs. The Task Force recommended that agencies competitively bid TGAs wherever possible on a service fee basis, and to eliminate compensating balances. This recommendation was accepted by the then Fiscal Assistant Secretary with the caveat that "*competitive bidding and the payment of fees would be pursued only to the extent that it is cost beneficial to do so".* The Treasury Department adopted this approach as part of its policy on the use of compensating balances on December 12, 1984.

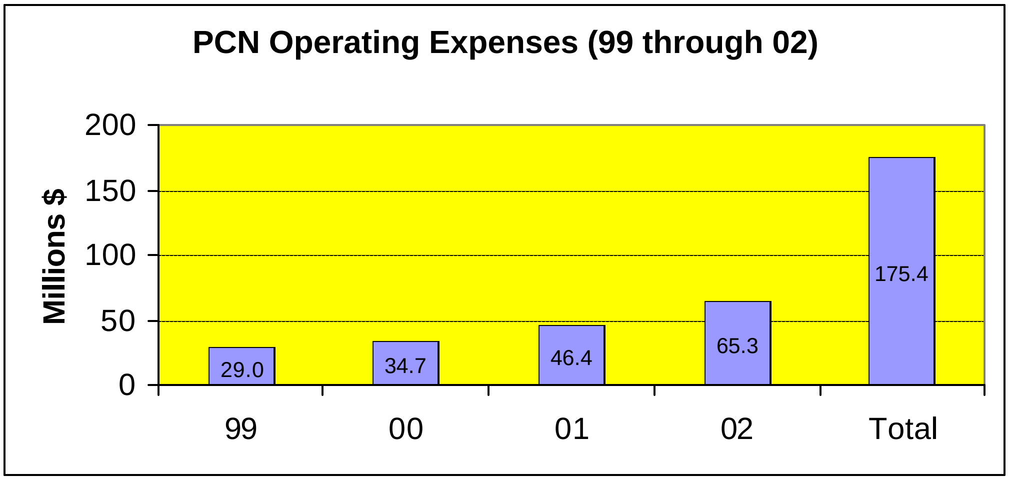
It should be noted that the *FY 2004 Budget of the United States Government*, issued as we were completing our audit fieldwork, proposed to establish a permanent, indefinite appropriation to allow FMS to reimburse financial institutions for services provided in their capacity as depositaries and fiscal agents for the United States. As stated in the Analytical Perspectives to the budget:

> *"[This proposal] is expected to simplify Treasury's cash and debt management, making it more efficient, especially when interest rates change sharply. The proposal is also expected to reduce the deficit, with the interest saved on lower borrowing being more than the outlays to pay for the services. The budget estimates savings of $637 million for the five years 2004-2008."*

FMS Does Not Have To Be Solely Responsible For Paying PCN Operating Costs

The objective of the PCN is to expedite the collection and depositing of revenues resulting from member agencies' credit and debit card sales. FMS manages the PCN for the benefit of member agencies and has through compensating balances paid for the operating expenses that result from those agencies' plastic card transactions. Through this arrangement, the Government has incurred $175.4 million in PCN operating expenses during the calendar year periods 1999 through 2002. (See Graph 3).

Graph 3



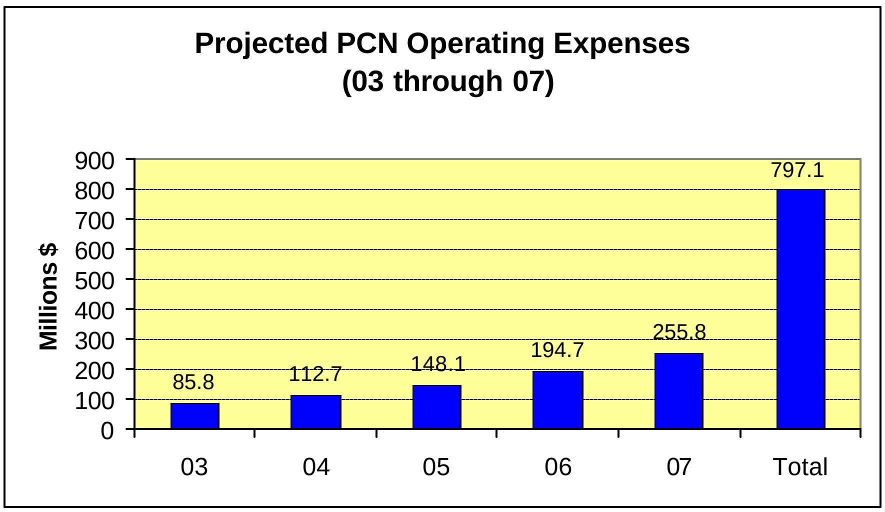
In contrast, publicly held corporations typically pass the cost of their plastic card operations on to consumers. In our survey of five publicly held corporations, we asked for their viewpoints and business practices on the cost of their credit card operations. They all stated that the expenses of credit card operations are recognized as a cost of doing business that they pass on to their consumers.

Officials we interviewed from two government agencies that operated their own plastic card networks said that related costs are, in effect, passed on to consumers. Also, we surveyed the six top dollar sales PCN member agencies on the likely actions they would take if they had to reimburse FMS for the operating costs of the PCN. The agencies' officials all stated that if they had to pay the cost, it would be passed on to the buyers of their goods and services in the form of increased prices.

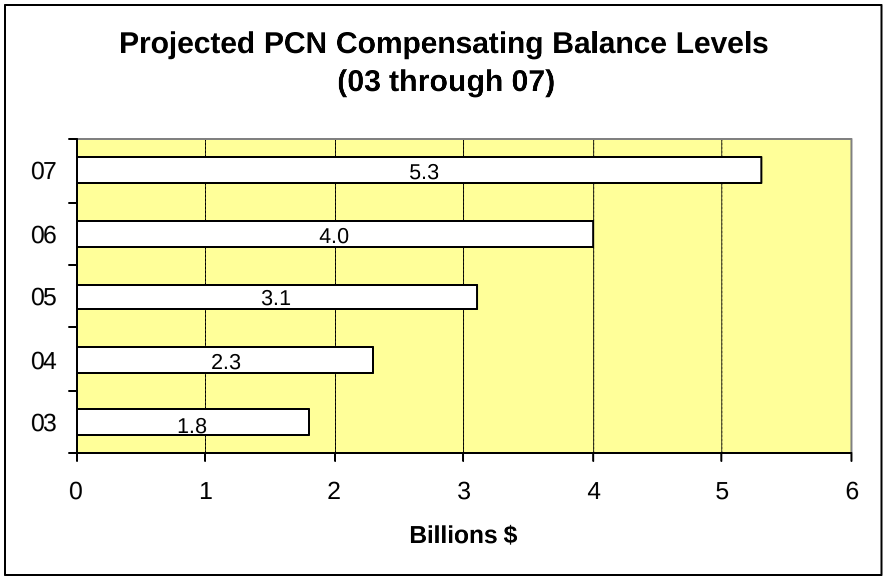
For the remaining five 1-year options of the financial agents' agreements, we estimate that the Government will incur an additional $797 million in PCN operating costs (See Graph 4). Also, the related level of compensating balances needed to fund these costs will increase to $5.3 billion by 2007 from the present $2.8 billion (See Graph 5).

Both of these projections are based on the average growth of expenses from calendar years 1999 through 2002 as billed by the two financial agents as well as the average earnings rate of the 3-month Treasury security as measured in the same time frame.

Graph 4



Graph 5



Recommendations

The Commissioner of FMS and the Fiscal Assistant Secretary should jointly consider the following actions:

1. If the current practice of paying for the PCN costs is continued, then a study should be done to compare the financial impact of using different securities' rates to determine the rate that provides the most cost benefit to the Treasury Department. Such documented analyses should be updated on a periodic basis, but minimally, at the point in time when each contract is awarded or option renewed.

Management Response

FMS is pursuing two alternative methods for compensating financial agents: (1) Congressional approval of a Permanent Indefinite Appropriation which will authorize FMS to pay financial agent fees directly, and (2) the issuance of Depository Compensation Securities (DCS) which will allow Treasury to compensate financial agents through the payment of interest earned on these special bonds. If neither of these methods can be implemented, FMS will study the legal and financial impacts of computing the imputed interest on compensating balances using the interest rate on securities with a term that closely matches the expected term of the compensating balance.

OIG Evaluation

We believe this recommendation to have a management decision. However, final action is pending the outcomes of FMS' two alternative methods identified in their response or the study that would be conducted if these methods were not implemented. In its response, FMS did not provide a projected date for completing its corrective actions.

2. In the FMS' annual budget justification, provide narratives that fully disclose all pertinent cost-benefit information in the use of imputing interest on compensating balances to reimburse financial agents for banking services provided.

Management Response

FMS will continue to disclose in its annual budget justification to Congress the costs of services, the amount of compensating balances, and the savings that result in the net interest earnings.

OIG Evaluation

We believe the justification narratives do not fully disclose the financial impact of imputing interest on compensating balances. For example, the long-standing Treasury practice of using the 3-month Treasury bill rate, instead of an interest rate that more closely matches the expected term of the compensating balance, has resulted in millions of dollars of foregone interest. This financial gap is not reflected in the budget justification and, therefore, decision-makers do not have the full breadth of information available in order to make funding commitments.

We believe this corrective action is pending the outcome of those actions identified in the Management Response to Recommendation 1 regarding a possible study to change the securities rate.

3. Future awards or agreement renewals to be paid on a service fee basis. Also, consider the option of having the PCN member agencies pay for their own respective transaction fees and charges.

Management Response

Financial agents currently charge on a service fee basis. FMS will evaluate the option of requiring agencies to pay their own transaction fees and charges.

OIG Evaluation

We believe this recommendation to have a management decision. In its response, FMS did not provide a projected date for completing its corrective action.

Finding 2 Management Controls For The Review, Recording, And Accounting For PCN Cost Data Need To Be Strengthened

The FMS did not establish complete and effective management controls over its administration of the PCN. Weak controls existed over critical processes within the Electronic Banking Services Division (EBSD) and in the Applied Technology Division's (ATD) review of financial agents' monthly billing of PCN costs. These weaknesses were attributed, in part, by the FMS not establishing comprehensive operating procedures for the PCN. As a result, we found errors in the calculations of the FMS' earnings on compensating balances and overpayments to financial agents of approximately $1 million. In addition, we could not be assured that payments to financial agents, made over a 4-year period, of over $124 million did not contain overcharges and/or undercharges.

Inadequate Controls Over Critical Processes Within the EBSD

Some of the key operational functions of the EBSD did not have sufficient management oversight to adequately safeguard the PCN assets. This Division is responsible for: (a) calculating and recording the imputed earnings on PCN compensating balances; (b) recording the PCN charges; and (c) computing the compensating balances net position. Because these functions do not receive a corroborative external review within FMS, errors in calculating earnings or posting of expenses may not be discovered.

The EBSD transfers compensating balance funds from the Treasury to the financial institutions. It also effects, when needed, adjustments in those balances that result from increases or decreases in PCN expenses or changes in interest rates.
To perform these functions, the EBSD maintains an *Earnings and Expenses Worksheet* for each compensating balance. Monthly, EBSD staff record on each *Worksheet*: (a) the amount of the compensating balance; (b) the earnings credit rate (the 3-month Treasury bill rate); (c) total dollars earned on the compensating balance (the imputed interest); (d) PCN expenses incurred by the financial agents; (e) the earnings minus expenses; and (f) a to-date net position (accumulated amount owed to either the financial agent or the FMS). An EBSD team leader gives an electronic version of the W*orksheet* a cursory review. The EBSD obtains the PCN expense data from the ATD's copy of the financial agents' billing statements and the earnings credit rate from the Federal Reserve Board website. In the case of the PCN, there were two compensating balances; one with the BOA for $2.3 billion and the second with Mellon for $500 million for a total of $2.8 billion.

FMS attempts to maintain the compensating balances at a level that earn sufficient imputed interest to cover the PCN expenses. If the imputed interest amounts are consistently above PCN expenses, the balance is lowered, and vice versa.
In this regard, the *Earnings and Expenses Worksheet* is an important management tool.

We compared the monthly PCN expense amounts recorded on the *Earnings and Expenses Worksheet* to the financial agents' billing statements for the 4-year period of January 1998 through December 2001. We were not able to perform this test for October 1998, December 1998, and January 1999 for Mellon because neither FMS nor Mellon could locate the related monthly billing statements, and Mellon was unable to reproduce the billing information. We noted 6 exceptions in our test. In each of these instances, the amounts of the PCN expenses recorded on the *Worksheet* exceeded the financial agents' monthly billing statements. These errors resulted in excessive compensation to the financial agents for PCN services totaling approximately $952,000 during the period. EBSD staff were unable to explain why these exceptions occurred.

In a separate test, we recomputed the monthly-imputed interest earnings recorded on the *Worksheet* for the same 4-year period, noting the following exception: in computing the earnings for one compensating balance FMS used the incorrect number of days (365 instead of 366) resulting in compensating balance earnings being overstated by approximately $57,000. When informed of this error, the FMS staff stated that an adjustment would be made to correct the error.

Incorrectly calculating the earnings credit amount on its compensating balances, or in posting PCN expenses on the *Earnings and Expenses Worksheet* results in either overpaying or underpaying the financial agent for program expenses. This is particularly important in light of the fact that, for September 2001 alone, FMS paid over $33 million, of which $3.5 million was for the PCN, in expenses for all programs paid via the compensating balance method.

Because these critical functions are solely performed in the EBSD using PC-based software, any errors in calculating compensating balance earnings or recording related monthly expenses will likely go undetected due to a lack of proper management control and external verification.

OMB Circular A-123 requires that management controls provide reasonable assurance that assets are safeguarded against waste, loss, unauthorized use, and misappropriation.

Inadequate Review of Financial Agents' Monthly Billing Statements

There were no indications that financial agents' monthly billing statements for PCN fees and charges were being consistently or adequately reviewed. Accordingly, fees and charges of over $124 million may include errors and over/under charges.

We reviewed available BOA and Mellon consolidated billing statements for the 4-year period of January 1998 through December 2001. During this period, the total amount of PCN fees and charges billed by the financial agents was over $124 million.

FMS personnel stated that a staff member in the ATD reviews and initials each monthly statement and subsequently provides it to the ATD Director who also reviews and initials it. However, we found only 3 (6%) BOA statements were initialed as reviewed by both a staff member and Director. Similarly, only 6 (13%) Mellon statements were initialed as reviewed by both a staff member and Director. There were no indications that the remaining statements were ever reviewed. All statements that were initialed as combined staff/Director-reviewed were for billing dates of May 2001 or later.

We also found that those billing statements that the ATD reviewed did not ensure that the FMS is charged only the allowed fees and charges for each PCN transaction. The financial agents' monthly billing information was provided to the FMS in a summary format. It did not allow for verifying either the fees for individual transactions are correct or that the consolidated statement of all monthly transactions did not include erroneous fees and charges.

The ATD receives monthly billing statements from BOA and Mellon. The transaction fees and other charges are provided in three different formats: (1) by individual agency; (2) by retail location within each agency; and (3) consolidated for all agencies. Each month, a staff member in the ATD compares the fees and charges identified on the consolidated statements, and a sample of the individual agency statements, to ensure they are identical to those stipulated in the agreement. Then, for a sample of transactions, the fee/charge rate will be applied against the aggregated transaction amounts to ensure the mathematical accuracy of the total charges. In addition, on a monthly basis, the ATD staff will perform a sample review to mathematically verify that the total retail location fees agree with the individual agency fee total. No individual transaction fee information is listed on any of the above three billing formats.

Only the FMS can verify transaction fees and charges because the financial agents provide the PCN member agencies with only collection deposit information.

Detailed Financial Agents' Billing Data Was Not Available

The financial agents' billing data that comprised their respective PCN fees and charges were unauditable. They could not provide us with all costs associated with our sample of individual PCN transactions. Such data were maintained only in summary form by fee categories within a group of transactions. FMS did not require the financial agents to maintain the fee data on a per transaction basis. Therefore, we were unable to audit this data in terms of being able to attest to the accuracy of a particular transaction's associated charge/fee.

We requested billing data from both financial agents in a format whereby we could identify individual transactions with all its associated charges. Although the financial agents have systems that compile PCN information in a variety of formats, they were unable to provide the data in our requested format. We attempted to work with the financial agents to achieve this goal, as explained in Appendix 2 to this report, but to no avail. Accordingly, we found the data unauditable for the objective of our test which was to determine if PCN charges and fees had an audit trail associated with specific transactions. Therefore, we are unable to form an opinion as to the accuracy of the transaction fees.

OMB Circular A-123 states, “The documentation for transactions, management controls, and other significant events must be clear and readily available for examination.”

In addition, the financial agent agreement, section 12, states that “The Financial Institution shall maintain, for a 7-year period, books or records sufficient to properly support all claims for compensation in the performance of the PCN services and FMS shall have the right to inspect and audit such books and records.” We believe that FMS should have required the financial agents to maintain fee data in a per transaction format so that it can be reviewed. Officials of the financial agents told us that FMS never objected to the present data format.

The above cited management control deficiencies are due to the absence of detailed operating procedures, and to the FMS not requiring its two financial agents to structure their monthly billing statements in a format that would allow FMS to effectively review fees and charges for PCN transactions.

Recommendations

The Commissioner of FMS should:

1. Ensure that the EBSD staff performs a thorough and detailed review of the information received from the FMS program areas and that related entries to the *Earnings and Expenses Worksheet* be reviewed and approved by a supervisor.

Management Response

FMS management has implemented procedures to ensure that (1) EBSD staff perform a review of the information received from FMS program areas, (2) the Team Leader reviews and approves the *Earnings and Expenses Worksheet*, and (3) the Emerging Technology Division Director verifies the accuracy of PCN charges before they are submitted to EBSD.

OIG Evaluation

We believe this recommendation to have a management decision. In its response, FMS did not provide the date the corrective action was taken.

2. Require the financial agents to maintain and retain their fee data that supports the underlying transaction charges in a format that would allow the FMS to review for accuracy at the transaction level.

Management Response

FMS management will require the financial agents to maintain and retain easily retrievable fee data.

OIG Evaluation

We believe this recommendation to have a management decision. In its response, FMS did not provide a projected date for completing its corrective action.

3. Ensure that the ATD performs a periodic, statistically based sample review of financial agents' transaction fees. Alternatively, FMS should consider requiring on future PCN agreements that the financial agents engage an independent public accounting firm to conduct periodic audits of the internal controls over transaction fees and charges.

Management Response

FMS performs monthly sample reviews of financial agents' transaction fees. In the future, FMS will require the financial agents to engage an independent public accounting firm to conduct periodic audits of the internal controls over transaction fees and charges.

OIG Evaluation

We believe this recommendation to have a management decision. In its response, FMS did not provide a projected date for completing its corrective action.

4. Ensure that the Director of the ATD documents his/her review and approval of each monthly consolidated billing statement.

Management Response

Effective July 1, 2002, Emerging Technology Division's (ETD) written procedures (formerly the Applied Technology Division) require that the ETD Director, PCN Team Leader and staff member review and approve all expenses.

OIG Evaluation

We believe this recommendation to have a management decision with a final action date of July 1, 2002.

Finding 3 Information Technology Security Control Reviews Were Not Performed And PCN Systems Were Not Recertified

Reviews of security controls of the PCN systems at the financial agents' and their subcontractors' sites were not performed, and these systems continued to function without the required recertification. Neither the FMS nor the financial agents had standard operating procedures in place to ensure that such reviews were performed and in a timely fashion. As a result, the FMS is unable to determine that PCN system safeguards remain sufficient to counter threats and vulnerabilities.

In 1998, the FMS initially performed reviews of security controls of the financial agents' and their subcontractors' systems as part of the award process for the PCN. However, FMS has not performed such reviews since that time. In addition, FMS did not follow-up on exceptions identified in the initial reviews.

Similarly, the financial agents have not performed security control reviews of their own systems. In addition, they neither performed such reviews of subcontractors' systems nor did they require subcontractors to have such reviews performed.

The FMS identified the security requirements for the PCN systems in its 1997 Invitation for Expressions of Interest in the Plastic Card Network. These requirements were later incorporated by reference in its agreements with the financial agents known as the Financial Agency Agreements. The financial agents made the commitment to comply with such requirements as evidenced by their technical responses to the Invitation for Expressions of Interest in the Plastic Card Network. The Invitation for Expressions of Interest in the Plastic Card Network required the selected financial agents to ensure that risk analyses (or audits) and certifications of new computer facilities, applications systems, or those undergoing significant change are completed before production commences and that reviews and recertifications shall be performed at least once every 3 years.

Further, the Invitation for Expressions of Interest in the Plastic Card Network required the financial agents to comply with the Computer Security Act of 1987, (Public Law 100-235), and all applicable standards and regulations established thereunder, and assure that an appropriate level of security is established for the PCN.
In addition, OMB Circular A-130 requires reviews of the security controls in each system when significant modifications are made,

but at least every 3 years. The scope and frequency of the review should be commensurate with the acceptable level of risk for the system.

Since the award of the agreements, more than 4 years have passed without system recertifications. Also, both financial agents had changes in both operational facilities and subcontractors supporting the PCN. Both of these events should have required a review of security controls. In addition, the financial agents did not inform the FMS when there were changes in subcontractors.

Neither FMS nor the financial agents had standard operating procedures requiring that such reviews be performed. Nonexistence of the related procedures represents an absence of an important control that could ensure that such reviews and related recertifications are consistently and timely performed.

The FMS cannot determine if system safeguards remain sufficient to counter changing threats and vulnerabilities without periodic risk assessments. Without an independent risk assessment, the FMS cannot be assured that information about private citizens, for example, bank account or credit card information, is not being improperly used or transmitted to a prohibited third party.

These findings were discussed, and agreed to, jointly with FMS management and the responsible financial agent representatives at the conclusion of the site visits.

Recommendations

The Commissioner of FMS should ensure that:

1. The ATD develops standard operating procedures for systems security control reviews and systems recertifications in accordance with applicable laws and regulations.

Management Response

Effective March 2003, ETD implemented PCN standard operating procedures for systems security control reviews, audits, and systems (re)certification and accreditation in accordance with both the Invitation for Expression of Interest and the requirements described in the Entity-wide IT Security Policies and Standards Manuals and the FMS Certification and Accreditation Handbook.

OIG Evaluation

We believe this recommendation to have a management decision with a final action date of March 2003.

2. The ATD takes the actions necessary to recertify and accredit the PCN at the financial agents' and subcontractors' facilities.

Management Response

ETD is in the process of recertifying and accrediting the PCN systems at the financial agents including their subcontractors.

OIG Evaluation

We believe this recommendation to have a management decision. In its response, FMS did not provide a projected date for completing its corrective action.

3. Each financial agent certifies annually to the FMS that all PCN-related systems, at financial agent facilities and those of subcontractors, do have current certifications.

Management Response

ETD now requires that both financial agents (including their contractors) provide to FMS an annual certifying statement.

These statements will confirm that the PCN-related systems have not undergone any changes and/or modifications that invalidate the certification and accreditation of the PCN.

OIG Evaluation

We believe this recommendation to have a management decision. In its response, FMS did not provide an implementation date for completing its corrective action.

* * * * *

Please be advised that we are recording in the Joint Audit Management Enterprise System (JAMES), $2.8 billion and $797 million respectively as funds that could potentially be put to better use relating to the recommendations in Finding 1 for more effective payment options for reimbursing financial agents for PCN operating expenses. These recommendations are identified in Appendix 3 of our report. We will also include these amounts in the OIG Semiannual Report to the Congress.

We would like to extend our appreciation to FMS for the cooperation and courtesies extended to our staff during the review. If you have any questions, please contact me at (202) 927-6512.

/s/
Donald R. Kassel
National Director, Banking and Fiscal Service Audits

The objectives of this audit were to determine how effectively the FMS has (1) monitored the performance of the PCN financial agents and subcontractors, and (2) controlled PCN costs.

To accomplish these objectives we: (1) reviewed documentation on the PCN such as agreements between the FMS, financial agents, and subcontractors; (2) interviewed FMS staff to determine the roles, responsibilities and procedures in use for the management of the PCN; (3) reviewed policies and procedures on the use of compensating balances; (4) interviewed representatives of other Federal agencies, as well as corporate officers of entities that manage networks similar to the PCN; and (5) obtained feedback on PCN performance from member agencies.

We reviewed PCN transaction data that covered the period January 1998 through December 2001. We reviewed the cost effectiveness of various methods of paying for PCN operating costs, as well as the effectiveness of management and information technology controls. Our fieldwork included the review of the Invitation for Expressions of Interest in the Plastic Card Network and related technical and pricing proposals; review of financial agents' monthly billing statements; and the procedures for calculating and reporting of the imputed interest rate the FMS receives on its compensating balances.

We performed our fieldwork between October 2001 and April 2002 at the FMS headquarters in Washington, DC. We performed onsite work at BOA's branch office in Washington, DC; Mellon's headquarters in Pittsburgh, PA; and Total Payment System in Columbus, Georgia (subcontractor to BOA). We conducted our audit in accordance with generally accepted government auditing standards.

We could not determine the accuracy of the PCN transaction fees because the information contained within financial agents' systems and provided in billing statements is in summary form only. Neither financial agent was able to provide us with the requested information in a format that allows for an audit trail of fees associated with specific transactions.

Our attempts to test this data follow:

Bank of America

We were able to identify and select a random sample of 273 individual transactions for review. The sample was selected from a 12-month period of transactions from March 2001 through February 2002. The related universe contained $29.6 million in fees assessed on 30.9 million transactions. Projected test results from this sample size would have given us a 90% confidence level.

We extracted the sample transactions using the Bank of America Merchant Services System (BAMRS). Because BAMRS does not record the interchange fee category, we could not use this system to obtain fees assessed on individual transactions. We decided to try an alternate method for obtaining the assessed fees. We learned that Bank of America receives two summary reports from the Total Payment System (subcontractor). The first is the Daily Merchant Deposit Total Report that lists the specific deposit batch and the total interchange categories by card type. The second is the Bank of America Merchant Services, Inc. Interchange Summary Report that contains summarized debit/credit card type interchange fees assessed to merchant activity on a monthly basis.

We recognized that some of the data contained in the two reports was useful. For example, the two reports contained deposit batch numbers. We attempted to reconcile the deposit batch number in BAMRS to the deposit batch number in the Interchange Summary Report. Since BAMRS recorded the deposit batch number and the two reports' total deposits reconciled, we thought that the per transaction fees might be included and captured in Total Payment System's report(s). However, additional research confirmed that it was not available in a useful format and had to be manually assembled by Bank of America personnel on a PC-based spreadsheet. Since we could not independently confirm the data listed on the spreadsheet, we could not attest to its reliability.

Mellon Bank

Mellon Bank's system did not allow for the extraction of PCN data to the transaction level. We wanted to extract a similar statistically based sample of transactions as we did with Bank of America. However, we learned that Mellon Bank takes the individual data and summarizes the information into spreadsheets, which are used for invoice submission to the FMS. The raw data Mellon uses to compile the summarized data is only available for thirty days after the close of the billing month. It then loses its PCN identity and is archived with other customer data.

The term ”recommendation that funds be put to better use” means a recommendation that funds could be used more efficiently by the Government if management took actions to implement and complete the recommendation. The implementation of the following recommendations in this report involve funds that could be put to better use. The related amounts will be recorded in the Joint Audit management Enterprise System (JAMES) and included in the statistical reporting in the next OIG Semiannual Report to the Congress.

Recommendation Number	Potential Funds That Could Be Put To Better Use
Finding 1 – Recommendation 1	$2.8 billion
Finding 1 – Recommendation 3	$797 million

The funds associated with Recommendation 1 represent the total amount of compensating balances maintained at the two PCN financial agents at end of 2001 that could be returned to the Treasury general fund, and thus available for other Government uses, if an appropriation is established to pay financial agents directly for the costs of operating the PCN. In this regard, as noted in FMS' management comments, the President's FY 2004 budget requested congressional approval for a permanent, indefinite appropriation to pay financial agents directly. It should also be noted that as an interim measure, the Department announced on July 3, 2003, that it plans to begin issuing non-marketable securities, called Depositary Compensation Securities, to compensate financial agents for essential banking services provided to the Government and phase out compensating balances.

The funds associated with Recommendation 2 represent the potential savings that could be realized over the remaining 5 one-year options of the PCN financial agent agreements if PCN member agencies were charged by FMS for their respective transaction fees and charges. The estimated amount is based on an assumption that PCN costs will continue to grow during the period 2003 through 2007 at an annual rate of 31.4 percent, which was the average annual growth rate of actual PCN costs during the period 1999 through 2002. The potential savings is also based on an assumption that the PCN member agencies include PCN-related charges when pricing goods and services for which credit cards are accepted.

COMMISSIONER

DEPARTMENT OF THE TREASURY
FINANCIAL MANAGEMENT SERVICE
WASHINGTON, D.C. 20227

APR 30 2003

MEMORANDUM FOR DONALD R. KASSEL, NATIONAL DIRECTOR
BANKING AND FISCAL SERVICE AUDITS

FROM: for RICHARD L. GREGG Kenneth R. Papaj

SUBJECT: Response to Draft Audit Report - Additional Control and Oversight Needed to Reduce Costs and Improve the Plastic Card Network

This memorandum was prepared in response to the draft audit report, Additional Control and Oversight Needed to Reduce Costs and Improve the Plastic Card Network (PCN), dated March 31, 2003. The Financial Management Service (FMS) concurs with all the Office of Inspector General's recommendations. Our efforts to address the audit findings have been on-going throughout the duration of this audit.

FMS has taken a closer look at external and internal management controls to improve the PCN. Specifically, both the Emerging Technology Division (formerly Applied Technology Division) and the Electronic Banking Services Division have evaluated the PCN program and have taken the following steps:

1) considered alternative ways to reimburse financial agents for operating expenses;
2) determined prudent measures for managing the financial agents;
3) streamlined operating procedures while adding more guidance and oversight; and
4) ensured that information technology systems of the sub-contractors, particularly those that provide merchant and transaction processing services, operate effectively and securely.

FMS will take the necessary steps to strengthen the program and systems in accordance with the guidelines established in the Invitation for Expression of Interest for the PCN. A detailed corrective action plan will be developed after a thorough analysis of the recommendations is completed. In the attachment, we have addressed the status of actions taken as of this writing.

We appreciate the opportunity to review and provide input to this draft report. If you want to discuss the corrective actions, you may contact Bettsy Lane, Assistant Commissioner, Federal Finance on (202) 874-6720.

Attachment

cc: Don Hammond

Attachment

Status of Actions

Finding 1

Recommendation 1: The Commissioner of FMS and the Fiscal Assistant Secretary should jointly consider the following actions:

a. If the current practice of paying for the PCN costs is continued, then a study should be done to compare the financial impact of using different securities' rates to determine the rate that provides the most cost benefit to the Treasury Department. Such documented analyses should be updated on a periodic basis, but minimally, at the point in time when each contract is awarded or option renewed.

Response:

FMS is pursuing two alternative methods for compensating financial agents:
1) Congressional approval of a Permanent Indefinite Appropriation which will authorize FMS to pay financial agent fees directly, and 2) the issuance of Depository Compensation Securities (DCS) which will allow Treasury to compensate financial agents through the payment of interest earned on these special bonds. If neither of these methods can be implemented, FMS will study the legal and financial impacts of computing the imputed interest on compensating balances using the interest rate on securities with a term that closely matches the expected term of the compensating balance. If FMS pursues this methodology, it will assess the appropriate security rate to utilize both at the time it designates a financial agent and at appropriate intervals thereafter.

b. In the FMS' annual budget justification, provide narratives that fully disclose all pertinent cost-benefit information in the use of imputing interest on compensating balances to reimburse financial agents for banking services provided.

Response:

As it has in the past, FMS will continue to disclose in its annual budget justification to Congress the costs of services, the amount of compensating balances, and the savings that result in the net interest earnings. In addition, as decisions are made regarding the use of compensating balances or other funding sources, FMS will continue to provide information in our Congressional budget submission on the cost of services and the amounts of those funding sources.

c. Future awards or agreement renewals to be paid on a service fee basis. Also, consider the option of having the PCN member agencies pay for their own respective transaction fees and charges.

Response:

PCN financial agents currently charge on a service fee basis. We will evaluate the option of requiring agencies to pay their own respective transaction fees and charges.

Finding 2

Recommendation 1: The Commissioner of FMS should:

a. Ensure that the Electronic Banking Services Division (EBSD) staff performs a thorough and detailed review of the information received from the FMS program areas and that related entries to the *Earnings and Expenses Worksheet* be reviewed and approved by a supervisor.

Response:

FMS' EBSD has implemented procedures to ensure that: (1) EBSD staff perform a thorough and detailed review of the information received from FMS program areas, (2) the EBSD Bank Management Team Leader reviews and approves the *Earnings and Expenses Worksheets*, and (3) the Emerging Technology Division (ETD) Director verifies the accuracy of PCN charges before they are submitted to EBSD.

b. Require the financial agents to maintain and retain their fee data that supports the underlying transaction charges in a format that would allow the FMS to review for accuracy at the transaction level.

Response:

FMS has obtained a sampling of fee data from the financial agents that supports the underlying transaction charges. However, these fee data are included within multiple reports and require manual intervention to compile. In the future, FMS will require the financial agents to maintain and retain easily retrievable fee data.

c. Ensure that the Applied Technology Division (ATD) performs a periodic, statistically-based sample review of financial agents' transaction fees. Alternatively, FMS should consider requiring on future PCN agreements that the financial agents engage an independent public accounting firm to conduct periodic audits of the internal controls over transaction fees and charges.

Response:

FMS performs monthly sample reviews of financial agents' transaction fees. In the future, FMS will require the financial agents to engage an independent public accounting firm to conduct periodic audits of the internal controls over transaction fees and charges.

d. Ensure that the Director of the ATD documents his/her review and approval of each monthly consolidated billing statement.

Response:

Effective July 1, 2002, ETD's written procedures require that the ETD Director, PCN Team Leader and staff member review and approve all expenses.

Finding 3

Recommendation 1: The Commissioner of FMS should ensure that:

a. The ATD develops standard operating procedures for systems security control reviews and systems recertifications in accordance with applicable laws and regulations.

Response:

Effective March 2003, ETD implemented PCN standard operating procedures for systems security control reviews, audits, and systems (re)certification and accreditation in accordance with both the Invitation for Expression of Interest (based on Treasury Directive P 71-10) and FMS' certification and accreditation requirements as described in the Entity-wide IT Security Policies and Standards Manuals and the FMS Certification and Accreditation Handbook.

b. The ATD takes the actions necessary to recertify and accredit the PCN at the financial agents' and subcontractors' facilities.

Response:

Effective March 2003, ETD implemented PCN standard operating procedures for systems security control reviews, audits, and systems (re)certification and accreditation in accordance with both the Invitation for Expression of Interest (based on Treasury Directive P 71-10) and FMS' certification and accreditation requirements as described in the Entity-wide IT Security Policies and Standards Manuals and the FMS Certification and Accreditation Handbook. ETD is in the process of recertifying and accrediting the PCN systems at the financial agents (including their contractors).

c. Each financial agent certifies annually to the FMS that all PCN-related systems, at financial agent facilities and those of subcontractors, do have current certifications.

Response:

ETD now requires under the PCN standard operating procedures that both financial agents (including their contractors) provide to FMS an annual certifying statement. These certifying statements will confirm that the PCN-related systems have not undergone any changes and/or any modifications that invalidate the certification and accreditation of the PCN.

Office of Audit

Donald R. Kassel, National Director, Banking and Fiscal Service Audits
Michael Sinko, Audit Manager
Ehab Bestawrose, Auditor-in-Charge
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The Department of the Treasury

Fiscal Assistant Secretary
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Financial Management Service

Commissioner
Deputy Commissioner
Assistant Commissioner, Federal Finance
Director, Cash Management Directorate
Director, Emerging Technology Division
Director, Electronic Banking Services Division
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OIG Budget Examiner