United States General Accounting Office
Washington, DC 20548

Accounting and Information
Management Division

B-285674

July 26, 2000

Mr. Richard L. Gregg
Commissioner
Financial Management Service
Department of the Treasury

Subject: FMS' Monitoring of Lockbox Bank Operations: Internal Control Weaknesses Identified and Actions Taken

Dear Mr. Gregg:

We recently reported on the U. S. government's financial statements for fiscal year 1999.[1] In connection with fulfilling our requirement to audit these statements, we tested certain internal controls over cash receipts collected through lockbox banks and processed by the Department of the Treasury's Financial Management Service (FMS) on behalf of the federal government.[2] We also followed up on FMS' actions to implement recommendations we made last year to improve monitoring of lockbox bank operations.

On behalf of federal agencies, FMS enters into lockbox service agreements with commercial banks to collect certain payments made to the federal government. FMS uses two lockbox networks: the general network for all payments except federal taxes and the Internal Revenue Service (IRS) lockbox network for federal tax payments.[3] The banks establish post office boxes and electronic accounts to receive payments. The banks deposit the funds they collect in Treasury Demand Deposit Accounts until they transfer funds to the Treasury General Account at the Federal Reserve Bank of New York. They also submit collection reports to the federal agencies and FMS.

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[1] *Financial Audit: 1999 Financial Report of the United States Government* (GAO/AIMD-00-131, March 31, 2000).

[2] 31 U.S.C. 331(e) (1994).

[3] Network is the term used by FMS to describe the group of banks that provides lockbox services. FMS had agreements with four banks to provide lockbox services during fiscal year 1999. Each of these banks provides general and IRS lockbox services and has multiple lockbox sites. In fiscal year 1999, there were 11 lockbox sites nationwide.

The banks are responsible for safeguarding and processing the funds in accordance with their agreements with FMS and the federal agencies. FMS performs on-site reviews and requires that the banks obtain internal and external audits of their lockbox operations to determine the effectiveness of the banks' controls. FMS, lockbox banks, and each of the federal agencies for which the lockbox services are provided also establish memorandums of understanding. These three-party agreements set forth procedures for processing collections that are designed to meet the specific processing and reporting requirements of the individual federal agencies. The federal agencies are also responsible for monitoring lockbox operations and reporting any performance problems to FMS. Also, Treasury requires banks to pledge collateral to protect federal funds collected through their lockbox operations and deposited at the banks.[4] FMS initially establishes the amount of collateral each bank must pledge based on expected average daily deposits and then adjusts the amounts based on actual collection information obtained from the banks.

In fiscal year 1999, FMS reported total lockbox collections of about $288 billion, of which $269 billion was federal tax payments in the IRS lockbox network and $19 billion was nontax payments in the general lockbox network. Because funds collected through lockbox banks go directly to the banks, FMS must ensure that the banks adequately safeguard the collections they process. Thus, FMS' monitoring of lockbox banks' operations and collateral is intended to be a key internal control for providing reasonable assurance that funds collected through the lockbox banks are protected against fraud, waste, and mismanagement. The purpose of this letter is to advise you of certain internal control matters identified during our testing and to recommend improvements.

Results in Brief

FMS has taken significant steps to strengthen its monitoring of its lockbox bank operations but additional actions are needed to assure that federal collections are adequately safeguarded and properly processed. Last year, we reported on weaknesses in, and recommended improvements to, FMS' monitoring of lockbox operations related to on-site reviews and lockbox bank audits.[5] FMS has addressed our concerns related to on-site reviews. In addition, FMS acted on our recommendations related to requiring and providing guidance for lockbox bank audits. However, due to the timing of the bank audits, FMS had not obtained the results of such audits as of the end of our fieldwork. Thus, it was too early to assess the effectiveness of FMS' enforcement of the audit requirement, review of the audit results, and follow-up on weaknesses identified, if any, in lockbox operations, as we recommended.

[4] Title 31*, Code of Federal Regulations, Part 202,* requires lockbox banks to pledge collateral security in an amount required by the Secretary of the Treasury prior to receiving federal deposits.

[5] *Internal Controls: FMS' Monitoring of Lockbox Bank Operations Needs Improvement* (GAO/AIMD-99-219, August 20,1999).

In performing the fiscal year 1999 testing, we found that additional actions are needed to (1) follow up on problems at lockbox banks identified by the federal agencies for which the lockbox services are provided and (2) ensure the sufficiency of collateral pledged by the lockbox banks. Specifically, we found that while FMS performed some procedures to investigate thefts identified by one agency at its general lockbox bank site, FMS' actions did not include determining what deficiencies at the bank allowed such thefts to occur. Therefore, FMS was unable to assess whether the corrective actions taken by the bank were adequate to prevent such thefts from occurring in the future. Once we brought this matter to FMS' attention, FMS investigated the thefts further and found that additional controls were needed at the bank to adequately safeguard the collections. Also, we found that FMS had not monitored the sufficiency of the collateral pledged by the lockbox banks since 1995 when it entered into lockbox service agreements with the banks, even though its internal procedures require that reassessments be performed every 2 years. After we identified this problem, FMS reassessed the collateral pledged by the banks and found that three of the four lockbox banks were significantly undercollateralized. For example, at one bank, about half of its average daily collected balances of approximately $150 million during the peak tax collection periods were not covered by collateral. After its reassessment, FMS instructed the banks to pledge the additional collateral needed to cover the deficiencies and protect the government's collections.

Although the internal control matters discussed in this letter are not material in relation to the federal government's fiscal year 1999 financial statements, we believe they warrant your attention. Without effectively monitoring banks' lockbox operations, FMS does not know whether the banks are adequately safeguarding and properly processing billions of dollars of federal collections. To assist FMS management in addressing the matters we identified, this letter contains two detailed recommendations. In commenting on a draft of this letter, FMS informed us that it concurred with our findings and that it has actions in process to correct the matters we identified.

Scope and Methodology

To meet our objective of evaluating the effectiveness of FMS' internal controls over lockbox operations, we reviewed FMS' policies and procedures for performing on-site reviews and audits of lockbox bank operations. This included reviewing the guidelines and checklists used by FMS in performing on-site reviews and the guidance and instructions FMS issued to lockbox banks on internal and external audits of lockbox operations. We also observed physical safeguards over receipts and related taxpayer data at two IRS lockbox sites. We interviewed FMS officials, including the Assistant Commissioner for Federal Finance, Director of FMS' Cash Management Directorate, Director of FMS' Financial Services Division (FSD), and FSD's Bank Management Team Leader to determine the status of FMS' actions to correct problems identified in our prior year audit. We also reviewed FMS' corrective action plan for resolving the weaknesses we reported last year and status reports on actions taken. In addition, we reviewed the federal regulations that require lockbox banks to pledge collateral to cover collections deposited in Demand Deposit

Accounts and FMS' internal procedures for establishing collateral levels and monitoring the sufficiency of collateral pledged by the banks. Our work did not include evaluating FMS' methodology for reassessing banks' collateral levels or valuing the collateral pledged by the banks. We conducted our work from December 1999 through March 2000 in accordance with generally accepted government auditing standards. We requested comments on a draft of this letter from the Commissioner of FMS. The Commissioner's comments are discussed in the "Agency Comments" section of this letter and included in the enclosure.

Additional Actions Are Needed to Strengthen FMS' Monitoring of Lockbox Bank Operations

As in last year's audit, we identified weaknesses in FMS' monitoring of lockbox operations. The Comptroller General's *Standards for Internal Control in the Federal Government*[6] requires that management establish policies and procedures to provide reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition and transactions are executed accurately and timely in accordance with management directives. Although FMS has taken steps to address the weaknesses we reported last year, we found during our fiscal year 1999 audit that additional actions are needed to (1) follow up on problems at lockbox banks identified by the federal agencies for which the lockbox services are provided and (2) ensure the sufficiency of collateral pledged by the lockbox banks.

Follow-up on Identified Problems

Thorough follow-up on identified problems at lockbox banks is necessary to provide assurance that problems are corrected in a timely manner and that corrective actions are adequate to prevent similar problems from occurring in the future. However, we found that FMS did not perform thorough follow-up on thefts identified by one of the federal agencies at a general lockbox bank.

FMS officials told us that five instances of employee theft were identified at one of the general lockbox sites during fiscal year 1999. According to FMS officials, one of the bank's employees had stolen five checks that were sent to the bank with the agency payee line left blank. In this case, the agency discovered the problem and notified the bank after the agency was contacted by one of the remitters of the stolen checks. In a letter to FMS, while not describing the deficiencies that existed, the bank stated that it thoroughly reviewed its existing security procedures and had taken steps to improve its controls, such as enhancing mail opening procedures and using a stamp to complete the agency payee line. However, we found that FMS' original follow-up did not include determining what deficiencies at the bank allowed such thefts to occur and thereby assessing whether the actions taken by the bank, as stipulated in its letter, were adequate to safeguard collections against such thefts in the future.

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[6]GAO/AIMD-00-21.3.1, November 1999.

After we brought this issue to FMS' attention, FMS obtained additional information from the bank on the circumstances surrounding the thefts and determined that other control procedures were needed. For example, FMS found that the bank did not log incoming blank payee checks, a standard mailroom procedure to help ensure that checks are not lost or stolen. Also, the bank did not include blank payee checks in its "seeding" program--a control technique used by banks that involves submitting dummy or false transactions that include cash and other negotiable instruments, and tracking the results to determine whether staff are processing transactions in accordance with established procedures. FMS notified the bank that these procedures should be implemented immediately. FMS officials told us that they plan to verify that these controls are in place during the next on-site visit tentatively scheduled for summer 2000. FMS officials also said that they plan to include a requirement for "seeding" checks with blank payee lines in all lockbox bank agreements when such agreements are renewed in 2001.

Monitoring of Collateral Pledged by Lockbox Banks

FMS is responsible for determining the amounts and types of securities lockbox banks pledge as collateral to cover deposits in their lockbox Treasury Demand Deposit Accounts during peak and nonpeak tax collection periods.[7] FMS' internal procedures require that every 2 years, it reassess the sufficiency of the banks' collateral to cover these accounts. However, we found that FMS had not periodically reassessed the sufficiency of the banks' collateral, in accordance with its procedures, since 1995 when it initially entered into lockbox service agreements with the banks.

After we brought this issue to FMS' attention, it reassessed the amount of collateral the banks had pledged to cover lockbox funds deposited in their Demand Deposit Accounts and found collateral deficiencies ranging from 30 percent to 97 percent at three of the four lockbox banks. All three banks had collateral deficiencies for nonpeak tax collection periods. One of the banks had an average daily collected balance during the nonpeak collection period of $3.5 million and only had pledged collateral valued at $103,500--a 97 percent collateral deficiency. Another bank had a $79 million, or 52 percent, collateral deficiency for its peak tax collection periods in addition to a nonpeak deficiency. This bank had pledged collateral valued at about $71 million when it needed $150 million to cover its average daily collection balances. Based on the results of these recent reassessments, FMS required the three banks to pledge additional collateral to cover their Demand Deposit Accounts sufficiently during both peak and nonpeak collection periods. FMS' Bank Management Team Leader also told us that he assigned a staff analyst to serve as the focal point for monitoring all lockbox banks' collateral.

[7]FMS establishes two levels of collateral (referred to as peak and nonpeak levels) for the banks because of significant fluctuations in the amount of lockbox deposits during the year. Peak collateral levels are set to cover lockbox collections during the peak tax collection months of January, April, June, and September, and nonpeak levels are set to cover collections during the other 8 months.

Actions Taken by FMS to Improve Its Monitoring of Lockbox Bank Operations

Last year, we reported on weaknesses in FMS' monitoring of lockbox bank operations related to on-site reviews and bank audits and made recommendations for improvements. FMS developed a plan to address all of our recommendations and has already implemented our recommendation to perform on-site reviews of general lockbox bank operations. FMS has also taken steps to address our concerns related to bank audits.

Specifically, FMS established a requirement for the banks to obtain semiannual internal and biannual external audits of their IRS lockbox operations; provided the banks specific guidance on the scope and type of external audits or other services; and required the banks to deliver to FMS, by December 31 of each year, a schedule of the internal and external audits to be performed at its IRS and general lockbox operations. FMS also developed and implemented a policy that requires banks to provide it with copies of audit reports on the banks' lockbox operations and calls for FMS staff to review the audit results and follow up on any weaknesses identified by the auditors. According to FMS officials, the banks had scheduled internal audits beginning in January 2000 and the majority of external audits were scheduled for 2001. Due to the timing of the bank audits, FMS had not received the results of the audits as of the end of our fieldwork. Therefore, we were unable to assess the effectiveness of FMS' (1) enforcement of the audit requirement, (2) review of the audit results, and (3) follow-up to ensure that any weaknesses identified were corrected.

However, subsequent to our audit fieldwork, FMS advised us that it had received the internal audit reports of two lockbox banks. For one of the banks, the auditors reported instances of noncompliance and internal control weaknesses at its IRS and general lockbox operations. For example, the auditor found that cash remittances at one of the bank's general lockbox sites were not properly secured in safes before being deposited. The auditor also reported that a cash seeding program had not been established at the bank's general lockbox operation sites. FMS officials stated that as part of the next on-site review of this bank's lockbox operations, they will follow up with the bank to ensure that corrective actions are taken. The weaknesses identified in this audit further emphasize the importance of FMS' monitoring of required bank audits.

Conclusion

Without effective monitoring of lockbox bank operations through thorough follow-up on problems agencies identify at the banks, such as the thefts that occurred at one of the general lockbox banks, and periodic monitoring of the sufficiency of the collateral pledged by the banks, FMS does not have assurance that the banks are adequately safeguarding federal collections against loss or theft and processing collections in accordance with the terms of the lockbox agreements.

Because of the timing of the internal and external audits of the lockbox banks' operations, it was too early to assess the effectiveness of FMS' enforcement and review of the audits. We will continue to monitor FMS' efforts in this area. It is important that FMS continue with its plans to obtain and review the results of the bank audits and follow up with the banks and agencies to ensure that any weaknesses identified are corrected.

Recommendations

To correct the new weaknesses we identified in FMS' monitoring of lockbox operations, we recommend that the Commissioner of FMS direct the Assistant Commissioner for Federal Finance to ensure that the Financial Services Division (1) establishes procedures to thoroughly follow up on problems agencies identify at lockbox banks, such as the thefts identified at one of the general lockbox banks, to ensure that problems are corrected in a timely manner and that adequate corrective actions are taken to prevent similar problems from occurring in the future and (2) performs periodic reassessments of collateral pledged by lockbox banks, as prescribed in FMS' internal policies and procedures.

Agency Comments

In commenting on a draft of this letter, FMS concurred with our findings and recommendations. The Commissioner of FMS indicated that FMS will continue to strive for additional improvements to assure that federal collections are adequately safeguarded and properly processed. The Commissioner also stated that FMS is already taking actions to address the internal control matters that we identified and plans to have them completed by September 30, 2000. We plan to follow up on these matters during our audit of the federal government's fiscal year 2000 financial statements.

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This letter contains recommendations to you. The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on our recommendations. You should send your statement to the Senate Committee on Governmental Affairs and the House Committee on Government Reform within 60 days of the date of this letter. You must also send a written statement to the House and Senate Committees on Appropriations with the agency's first request for appropriations made over 60 days after the date of this letter.

We are sending copies of this letter to Senator Fred Thompson, Chairman, and Senator Joseph Lieberman, Ranking Minority Member, Senate Committee on Governmental Affairs; Representative Dan Burton, Chairman, and Representative Henry Waxman, Ranking Minority Member, House Committee on Government Reform; other interested congressional parties; the Honorable Lawrence Summers, Secretary of the Treasury; Donald Hammond, Fiscal Assistant Secretary, Department of the Treasury; the Honorable Jeffrey Rush, Jr., Inspector General, Department of the Treasury; and the Honorable Jacob J. Lew, Director, Office of Management and Budget. Copies will be made available to others upon request.

If you have any questions regarding this letter, please contact me at (202) 512-3406. Key contributors to this assignment were Christine Robertson, Suzanne Murphy, and Jerry Marvin.

Sincerely yours,

Gary T. Engel

Gary T. Engel
Associate Director
Governmentwide Accounting and
Financial Management Issues

Enclosure

Comments From the Financial Management Service

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

COMMISSIONER

July 11, 2000

Mr. Jeffrey C. Steinhoff
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Steinhoff:

Thank you for the opportunity to respond to your draft report, "FMS' Monitoring of Lockbox Bank Operations" (GAO/AIMD-00-225R). We concur with your findings that additional actions can be taken by the Financial Management Service (FMS) to assure that Federal collections are adequately safeguarded and properly processed.

Your report recommends that FMS establish procedures to thoroughly follow-up on problems identified by agencies at lockbox banks to ensure that problems are corrected in a timely manner and that adequate corrective actions are taken to prevent similar problems from occurring in the future. Specifically, this finding and recommendation relate to an incident where five checks stolen at a lockbox bank were undetected until pointed out by a remitter after the check was fraudulently negotiated. In order to address this finding, FMS will establish procedures by September 30, 2000, to document any incidents, identify deficiencies, outline corrective actions, and track results.

These procedures will require, among other controls, that:

- all network banks log remittance checks with blank payee lines and over stamp the check with the name of the appropriate Federal agency;
- all new lockbox agreements require seeding of cash and checks with blank payee lines to ensure that proper processing procedures are followed;
- incident reports be prepared to document each event; and
- FMS verify compliance with these procedures during annual on-site reviews.

Your report also recommends that FMS perform periodic reassessments of collateral pledged by lockbox banks as prescribed in FMS' internal policies. Based on the initial findings from your review, FMS has taken action to ensure that all banks in the general and IRS lockbox networks have sufficient collateral to cover current balances on deposit. On a monthly basis, FMS receives collateral holdings reports from the Federal Reserve which list the valuation of all securities held for each financial agent, and the financial agents report to FMS the average daily collected balance maintained in the Treasury accounts. To ensure continuing protection of Federal Government deposits, FMS will establish a procedure by August 31, 2000, which includes designating an analyst responsible for comparing these reports monthly to verify that sufficient collateral is on hand at the Federal Reserve to cover deposits held overnight by the financial agents.

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We appreciate your recognition of our continuing improvements as well as your suggestions for further enhancements. We look forward to an ongoing relationship and will continue to strive for additional improvements to assure that Federal collections are adequately safeguarded and properly processed.

Sincerely,

Richard L. Gregg

Richard L. Gregg

cc: Donald V. Hammond

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