

**AUDIT
OF
POSTING LOANS**

January 31, 2001

Audit Division (SIV)

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EXECUTIVE SUMMARY

An audit of the accuracy of the posting loans receivable balance and the adequacy of management and administrative practices of the Foreign Service Directives Policy and Administration Division (HPM), responsible for posting loans, was conducted during September and October 2000.

The Audit Team cannot provide management with reasonable assurance that the posting loan balance of \$11,725,252 as reported in IMS on August 31, 2000 is accurate, because of the following weaknesses observed:

The Department's IMS cannot determine and display the net balance owing the Department from each loan recipient. It can only provide the total value of posting loans issued and posting loan receipts, with the loans receivable balance of \$11,725,252 being the difference;

The Department maintains the Annu-T system for posting loans. The total amount receivable per this system has not been reconciled to the \$11,725,252 as reported in IMS as of August 31, 2000;

The August 2000 "Report of Payments Difference Between the Pay List and Annu-T" identified that of 965 outstanding posting loans, 588 or 61% contained errors; and,

The Audit Team reviewed 64 of these errors and determined that 59% were administrative in nature while 41% were financial errors.

The following is a summary of the audit observations and recommendations:

- There is a requirement to ensure that posting loans transactions are reconciled with IMS. Corrective measures need to be taken immediately to detect and correct errors identified in the reconciliation between the pay list and Annu-T. All financial adjustments arising from the pay list and Annu-T reconciliation should be entered into IMS to ensure that the loan receivable balance is correct;
- HPM should consult with the Corporate Finance and Planning Bureau (SMD) to determine if there is a need to transfer part or all of the financial administration responsibilities from HPM to SMD;
- HPM needs to implement a monitoring and reporting mechanism for the posting loans function; and,

- Operating procedures and instructions should be developed and implemented to strengthen internal control over the function.

The Audit Team is concerned with the Department's control over its loans receivable. It is imperative that the situation be resolved by HPM in close consultation with SMD.

OBJECTIVES OF THE AUDIT

The objectives of the Audit were to:

- provide a reasonable level of assurance that the posting loan receivable balance of \$11,725,252 reported in IMS as at August 31, 2000 was accurate; and,
- assess the adequacy of management and the administrative practices.

SCOPE AND APPROACH

The audit covered a sample of posting loan transactions completed in the period April 1, 1999 to August 31, 2000 (17 months). The Audit Team reviewed and examined relevant documentation, including FSD 10, policy statements, instructions and records maintained in support of the posting loan function.

The audit was conducted in two phases. The preliminary survey identified a number of potential audit issues. The Audit Team and HPM reviewed these issues and decided a more detailed examination was required in the following areas:

- posting loans accounting system;
- reconciliation process;
- loan interest calculations;
- resourcing the function;
- monitoring and reporting; and,
- operating policies and procedures.

OBSERVATIONS AND RECOMMENDATIONS

1.0 Posting Loans Accounting System

1.1 The Treasury Board's policy on loans, requires that departments maintain an accounting system capable of displaying, at all times, the net balance owing to the

government from each recipient. Presently, IMS records the total dollar value of posting loans issued and posting loans receipts, loan receivables being the difference. There is no subsidiary ledger that shows individual loan balances for each loan recipient.

1.2 When the department changed over from FINEX to IMS, a loan module for posting loans was not developed within IMS. The Audit Team was advised that a management decision was made at that time not to purchase the loan module. This essentially left HPM without an accounting system to manage these loans. As a stop gap measure, HPM was advised to acquire a software package to manage the posting loans function (Annu-T). Annu-T is a database with loan calculation functions, it is not an accounting system, however, it can provide a declining balance of loan principal and interest receivable.

1.3 HPM is aware of the problems associated with not having a functioning loan accounting system and has approached SMD seeking a solution to its dilemma. Unfortunately, it does not appear that developing and implementing a loan module in IMS is a priority at this time. Nevertheless, some solution is required, particularly with the advent of accrual accounting April 1, 2001.

1.4 HPM does not have the expertise in-house to develop a business case for selecting an appropriate loan accounting system, and requires assistance in this regard. It is not known at this time if installing a posting loan module within IMS is the appropriate solution. Other options need to be explored before a final decision is made to address this issue.

Recommendation for HPM

1.5 HPM, in consultation with SMD, should develop and implement a posting loan accounting system that is capable of displaying the balance owing for each loan recipient.

HPM Response

1.5 SMD advised HPM that implementing a posting loan module within IMS would represent an enhancement which would need to be submitted to the Change Management Board (CMB) for prioritization. At present, there is a freeze on IMS development until next fiscal year. As a result, HPM will build a report within Annu-T that will provide the balances owing for each loan recipient. The report will be operational March 31, 2001.

2.0 Reconciliation Process

2.1 HPM does not have a functional reconciliation procedure to ensure all loan receivables are received and entered correctly into IMS. Currently, the reconciliation

process consist of a reconciliation between the PWGSC pay list (most employees repay their loans via deductions from their pay) and Annui-T, however, this reconciliation has not been completed since March 31, 1998. The August 2000 "Report of Payments Difference Between the Pay List and Annui-T" identified that of 965 outstanding posting loans, 588 contain errors (61%) that require correction and the appropriate adjustment entered into IMS in order for it to report the correct loan receivable balance. Because the adjustments have not been made, there was a difference of \$4,351,758 between the loan balance figures between Annui-T and IMS as of August 31,2000.

2.2 HPM is attempting to complete these reconciliations. It recognizes the importance of the reconciliation process and has recently hired additional staff to assist in getting this done. By the close of the audit, considerable progress had been made, with the difference between Annui-T and IMS reduced to less than \$1 million, but a great deal of work remains to be done.

2.3 It is important to complete the above reconciliations so that the appropriate adjustments can be entered into IMS. Since the financial adjustments have not been completed, the Audit Team cannot assure management that the amount of loan receivables reported in IMS is correct. The Audit Team was advised that the last time posting loans were reconciled to the general ledger was when FINEX was in use. In view of the financial implications of reconciling posting loans transactions to IMS, the Audit Team believes that SMD should be involved in the process. At the conclusion of the audit, the involvement of SMD in the reconciliation process had yet to be determined.

Recommendations for HPM

2.4 HPM, in consultation with SMD, should develop and implement reconciliation procedures that will ensure that the reconciliation is completed monthly and that all financial adjustments are entered into IMS.

2.5 HPM, in consultation with SMD, should develop and resource a formal work plan to eliminate the reconciliation backlog and to enter financial adjustments into IMS.

HPM Responses

2.4 HPM is currently reconciling the Pay List to Annui-T. When this reconciliation is completed the loans and interests receivable will be reconciled to IMS and the appropriate adjustments made. All reconciliations will be completed by March 31, 2001 and completed monthly thereafter to be FIS compliant.

2.5 HPM has developed a work plan and employed two temporary staff to complete the reconciliation plan by March 31, 2001. SMD has informed HPM that it will provide assistance to facilitate the financial adjustments into IMS.

3.0 Random Sample Results

3.1 During the survey phase, the Audit Team examined the August 2000 exception report "Report of Payments Differences Between the Pay List and Annu-T" and noted a very high error rate. The exception report noted that of 965 outstanding active posting loans, 588 (61%) contained errors. The team categorized the errors as follows:

- A. Payment called for per Annu-T loan schedules but no deductions reflected on Pay List (August/2000) - **49%** [288]
- B. Pay List deduction amount and Annu-T payment amount differed - **22%** [127]
- C. Rounding errors - \$0.01 and/or \$0.02 (not considered an error) - **29%** [173]

3.2 Using statistical sampling techniques a sample was selected to provide the Audit Team a 95% confidence level with a <5% error rate. This resulted in a sample size of 64 that focussed on "A" above. The following table summarizes the results of the test.

Table of Sampled Errors

Error Description	No. Errors	Percentage
<i>Administrative</i>		
1. Personal Record Identifier (PRI) set up in Annu-T with a hyphen and as such shows up as an exception since the Pay List PRI's are without hyphen.	18	28
2. August 2000 Annu-T amount is interest only and first deduction is scheduled to begin September 2000.	16	25
3. Miscellaneous (various minor administrative errors).	4	6
<i>Administrative Errors - Sub-total</i>	38	59

Error Description		No. Errors	Percentage
<i>Financial</i>			
4.	Loan payments are not being deducted properly in accordance with Annu-T loan schedule.	5	8
5.	No evidence of loan deductions per Pay List.	2	3
6.	No evidence of interest payments being received to cover time between receipt of loan and first payment.	3	5
7.	Loan paid-off and this is not reflected in Annu-T database.	13	20
8.	Loan paid-off, however, for an amount less than balance owing at the time of loan retirement.	1	2
9.	Loan file missing.	2	3
<i>Financial Errors - Sub-Total</i>		26	41
Error - Total		64	100

Interpretation of Test Results

Administrative Errors

3.3 Administrative errors are considered minor in that they do not affect the financial position of the department. It is believed that future exception reports would show significantly less administrative errors if the database was cleaned up.

Financial Errors

3.4 Financial errors are considered major in that they do affect the financial position of the department. The principal cause of these errors is loan payments not being deducted properly in instances where employees (borrowers) go on leave-without-pay. In these instances, the employees have their pay deductions stopped, but they are not resumed when they return to work. We observed this happening most frequently with employees of other government departments.

3.5 Another error noted is where there is no evidence of payroll deductions starting. While the number of occurrences (No. 5 in Table) is small in comparison to the total sample size (64), we would expect a lower error rate for financial transactions of this nature.

3.6 Another real concern is the high number of errors caused by not updating Annu-T to reflect the paid-off loans prior to the expiration of their terms (No. 7 in Table). This causes the current balance of outstanding loans to be significantly overstated. Many of these loans were paid-off more than a year ago. A 20% error rate reduces the level of assurance concerning the financial accuracy of current loan balances.

3.7 No evidence of interest payment for the period between loan receipt and first payment (No. 6 in Table) was noted in 3 cases. This is likely due to a general lack of a proper audit trail. However, an error rate that approximates almost 5% should not be tolerated.

3.8 In terms of the two missing files (No. 9 in Table), in both cases the loans were set-up in Annu-T, but there was no paper file to help explain why there were no pay deductions being made.

3.9 In summary, the Audit Team found the financial error rate was unacceptably high (maximum error rate expected <5% - error rate found 41%).

Recommendation for HPM

3.10 HPM should verify that all loans given between April 1, 1999 to September 30, 2000 are being deducted per Pay Lists. This will require that the validation exercise use IMS data and Pay List data. This will provide a higher level of assurance than the present reconciliation process (matching Pay Lists to Annu-T) that the department is recovering loans from employees through payroll deductions.

HPM Response

3.10 The verification procedure is included in our overall work plan as noted in HPM response 2.4 and 2.5.

4.0 Loan Interest Calculations

4.1 Loan payment calculations (blended principal and interest) are determined using Annu-T. The payment amount is based on monthly payments over the term of the loan whereas the loan is repaid through twice monthly payroll deductions. This method of calculation and repayment results in an overpayment of interest by the borrower. The Audit Team determined that the amount of interest overpayment is relatively small (less

than \$30 on a \$20,000 loan over a 48 month term). Nevertheless, interest should be arrived at using the proper method of calculation (bi-monthly frequency of payments versus monthly). This was discussed with management of HPM and it concurs.

4.2 The administrative cost associated with the calculation of each employee's overpayment would be significant, and the amounts are small. Because employees receive a interest rate that is always lower, often as much as 4%, than the rate charged by commercial banks and lending institutions for unsecured loans, the Audit Team believes that the preferential interest rate mitigates the need for Department to proceed with the calculation.

Recommendations for HPM

4.3 All future loan interest calculations should be completed using the bi-monthly frequency of payment method.

HPM Responses

4.3 Done

5.0 Resourcing the Function

5.1 It was evident during the survey phase that HPMX is not adequately staffed. More specifically, the workload, exacerbated by the backlog of reconciliation, is more than what the current staff can handle. During the conduct phase of the audit, HPM, in recognition of the reconciliation workload, authorized the hiring of additional staff to address this issue. However, given the financial nature of the posting loans function, the Audit Team believes that there is a need to consider transferring part or all of the financial aspects of the posting loans function to SMD. Workload statistics should be gathered to gain a better insight on the optimum number of staff and skill level required to effectively and efficiently administer the function.

Recommendations for HPM

5.2 HPM, in consultation with SMD, should consider transferring part or all of the financial administration requirements of the posting loans function to SMD.

5.3 HPM, in consultation with SMD, should begin gathering workload statistics with a view to determining the appropriate number of staff and skill level necessary to administer the function. The decision to transfer the function to SMD should not be made until after the analysis is completed.

HPM Responses

- 5.2 No resources were provided when the Posting Loan function was transferred to HPM in 1998. It is agreed that more support is required from SMD for the financial reconciliation function, however, it is recognized that most of this support would have to come through enhancements to IMS to allow better tracking of loan receivables. At the moment, IMS does not have this capability, and there is a freeze on changes.**
- 5.3 HPM has temporary support to bring figures up to date. New resources will be required to ensure a continuing reconciliation. HPM is in consultation with SMD/SMF on possible short and longer term improvements. Several options are being considered, including IMS improvements and possible contracting-out of the function. Once an option is selected, resource requirements will be determined.**

6.0 Monitoring and Reporting

6.1 The Account Executive, HPMX, reports directly to the HPM. Reporting for the most part is oral. Given that there are only two staff in HPMX, this is understandable. However, given the financial nature of the function, the workload and reconciliation backlog, the frequency of financial and administration errors in loan processing, and the inconsistencies in file documentation, the Audit Team would expect to find a more structured approach to monitoring and reporting. As a minimum, monitoring and reporting should be done for monthly reconciliations, accounts receivable and collections, and workload statistics.

Recommendation for HPM

- 6.2 HPM should establish a formal monitoring and reporting regime that will provide monthly reports on the status of the reconciliations, loans receivable, collections balances and workload statistics.**

HPM Response

- 6.2 The development of the monitoring and reporting regime is part of the work plan noted in response 2.4 and 2.5 and will be fully operational March 31, 2001.**

7.0 Operating Policies and Procedures

7.1 Foreign Service Directive - FSD 10, is the primary policy document from which HPMX administers the posting loan function. FSD 10 has been recently amended to be more precise concerning the when, how and limitations on renegotiating loans.

7.2 With the exception of FSD 10 and a Revenue Canada interpretation bulletin on interest taxable benefit, HPMX does not have formal desk procedures. Consequently, there are no written instructions for important elements of the posting loans function. For example, important activities such as: monthly reconciliation process; new loan process; renegotiation process; documentation control; recovery and collection; and, delegated authorities for FSD 10, are not documented for easy reference. In addition, inconsistencies in document control, noted during our sample testing could be alleviated through the development and implementation of a "Document Control and Process Checklist". Developing desk procedures will provide a means to ensure that important processes and procedures are known and followed consistently by new and existing personnel.

Recommendation for HPM

7.3 HPM should develop and implement appropriate desk procedures for the posting loans function. In addition, as a document control measure, develop and implement a "Document Control and Process Checklist".

HPM Response

7.3 Done.