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United States Government Accountability Office
Washington, DC 20548

June 30, 2010

The Honorable Herbert M. Allison, Jr.
Assistant Secretary for Financial Stability
Office of Financial Stability
Department of the Treasury

Subject: *Management Report: Improvements Are Needed in Internal Control
Over Financial Reporting for the Troubled Asset Relief Program*

Dear Mr. Allison:

The Emergency Economic Stabilization Act of 2008 (EESA)¹ requires that we annually audit the financial statements² of the Troubled Asset Relief Program (TARP) which is implemented by the Office of Financial Stability (OFS).³ On December 9, 2009, we issued our audit report⁴ including (1) an unqualified opinion on OFS's financial statements for TARP as of and for the period ended September 30, 2009, and (2) an opinion that OFS maintained effective internal control over financial reporting as of September 30, 2009. We also reported that our tests of OFS's compliance with selected provisions of laws and regulations for the period ended September 30, 2009, disclosed no instances of noncompliance.

Our December 9, 2009, audit report concluded that although certain internal controls could be improved, OFS maintained, in all material respects, effective internal control over financial reporting as of September 30, 2009, that provided reasonable assurance that misstatements, losses, or noncompliance material in

¹Pub. L. No. 110-343, Div. A, 122 Stat. 3765 (Oct. 3, 2008), *codified in part, as amended*, at 12 U.S.C. §§ 5201-5261.

²Section 116(b) of EESA, 12 U.S.C. § 5226(b), requires that the Department of the Treasury (Treasury) annually prepare and submit to Congress and the public audited fiscal year financial statements for TARP that are prepared in accordance with generally accepted accounting principles. Section 116(b) further requires that GAO audit TARP's financial statements annually in accordance with generally accepted auditing standards.

³Section 101 of EESA, 12 U.S.C. § 5211, established OFS within Treasury to implement TARP.

⁴GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements*, [GAO-10-301](#) (Washington, D.C.: Dec. 9, 2009).

relation to the financial statements would be prevented or detected and corrected on a timely basis. Our audit report also identified two significant deficiencies in OFS's internal control over financial reporting.⁵

This report presents (1) more details concerning underlying specific control deficiencies that contributed to the two significant deficiencies identified in our audit report, (2) other less significant control deficiencies that we identified during our audit, and (3) related recommendations for corrective actions. While the deficiencies we identified are not considered material weaknesses, they warrant management's attention and action. The recommendations presented in this report are in addition to those we have made as part of the series of reports issued on our ongoing oversight of TARP.⁶

Results in Brief

We identified two significant deficiencies in OFS's internal control over financial reporting concerning (1) accounting and financial reporting processes and (2) verification procedures over the data used for asset valuations.

The significant deficiency concerning accounting and financial reporting processes was the combination of several underlying specific control deficiencies. Specifically, (1) OFS did not effectively implement its review and approval process for preparing its fiscal year 2009 financial statements and related disclosures for TARP; (2) OFS had not finalized⁷ its written procedures related to its processes for accounting for certain program transactions, preparing its September 30, 2009, financial statements, and its oversight and monitoring of financial-related services provided to OFS by asset managers and certain financial agents; and (3) OFS did not have proper segregation of duties over a significant accounting database it uses in valuing its assets in that the same individual was responsible for performing both the data entry and the reconciliation of the data output. However, OFS had developed and implemented other controls over TARP transactions and activities that reduced the risk of material misstatements resulting from these deficiencies.

⁵A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

⁶Section 116(a) of EESA, 12 U.S.C. § 5226(a), requires GAO to report at least every 60 days on TARP activities and performance. Products and recommendations related to GAO's oversight of TARP are available on GAO's Web site at <http://www.gao.gov>.

⁷Procedures that had not been finalized were either in draft form, did not address certain specific issues, or had not yet been developed.

With regard to the second significant deficiency, OFS did not effectively implement its verification procedures for certain assumptions and data that were input into the economic and financial credit subsidy models used for the valuation of TARP direct loans, equity investments, and asset guarantees. OFS reduced the risk of misstatements resulting from this data verification deficiency by performing procedures to assess the reasonableness of the model outputs, including comparison of the asset valuations calculated by the model with independently performed valuations.

In addition to the two significant deficiencies, we identified other less significant control deficiencies related to (1) tracking executed agreements, (2) recording warrant transactions, and (3) reconciliations of disbursements to and refunds from the TARP custodian.

We are making 17 recommendations related to OFS's significant deficiencies and 3 recommendations related to the other less significant control deficiencies.

In commenting on a draft of this report, the Assistant Secretary for Financial Stability stated that OFS concurred with the recommendations in our draft report. The Assistant Secretary also stated that OFS began taking actions related to these recommendations in January 2010 following the release of our audit report and expects to have implemented corrective actions for all recommendations by September 30, 2010.

Scope and Methodology

As part of our audit of OFS's fiscal year 2009 financial statements for TARP, we evaluated the design and operating effectiveness of OFS's internal control over financial reporting. We tested relevant internal controls over financial reporting, including those designed to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in conformity with U.S. generally accepted accounting principles (GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in accordance with the laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements.

We did not evaluate all internal controls relevant to operating objectives as broadly established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting. Because of inherent limitations, internal control may not prevent or detect and correct misstatements

due to error or fraud, losses, or noncompliance. Additional details on our audit methodology can be found in our December 2009 audit report.⁸

We performed our audit of OFS's fiscal year 2009 financial statements for TARP in accordance with U.S. generally accepted government auditing standards. We believe that our audit provided a reasonable basis for our conclusions in this report.

We requested comments on a draft of this report from the Assistant Secretary for Financial Stability. In a letter dated June 17, 2010, OFS commented on our draft report. OFS's comments are reprinted in enclosure I.

Background

Since its inception on October 3, 2008, OFS has implemented numerous initiatives under TARP that were designed to help ensure overall stability and liquidity of the financial system and help preserve homeownership. During fiscal year 2009, OFS primarily made equity investments in and direct loans to hundreds of entities, including financial institutions and automotive companies; however, most of the value of its investments and loans was concentrated in a limited number of high-dollar transactions. Specifically, during fiscal year 2009, OFS disbursed about \$364 billion, of which \$318 billion (or 87 percent) was disbursed to 20 TARP participants, such as American International Group, Inc.; General Motors; Bank of America; and Citigroup. In addition, while OFS had started to implement its Home Affordable Modification Program (HAMP) during fiscal year 2009, the amounts disbursed were less than \$1 million through September 30, 2009.

During fiscal year 2009, OFS made significant progress in building a financial reporting structure for TARP, including developing an internal control system over TARP activities and transactions and addressing key accounting and financial reporting issues necessary to enable it to prepare financial statements for TARP and to receive an audit opinion on those statements, for the period ended September 30, 2009. However, OFS's financial reporting structure continued to evolve throughout the year as new TARP programs were implemented,⁹ which posed a challenge to OFS's ability to establish a comprehensive system of internal control while simultaneously reacting to market events and evolving TARP initiatives and responsibilities.

⁸GAO-10-301.

⁹For example, in October 2008, OFS established the Capital Purchase Program and purchased \$115 billion in preferred stock and warrants; in December 2008, Treasury announced and began implementing the Automotive Industry Financing Program; in March 2009, Treasury and the Federal Reserve announced the launch of the Term Asset-backed Securities Loan Facility; in August 2009, OFS began to make disbursements for the Home Affordable Modification Program; and, also in September 2009, OFS signed commitments to invest in limited partnerships under the Public-Private Investment Program.

Significant Deficiencies

The following sections present additional information concerning the specific underlying control deficiencies that contributed to the two significant deficiencies we identified related to (1) accounting and financial reporting processes and (2) verification procedures over the data used for asset valuations,¹⁰ along with our related recommendations for corrective actions.

Accounting and Financial Reporting Processes

While OFS had developed and implemented controls over TARP transactions and activities, we identified several specific control deficiencies that collectively represented a significant deficiency in OFS's internal control over its accounting and financial reporting processes. Specifically, OFS did not effectively implement its review and approval process for preparing its financial statements and related disclosures for TARP. In addition, OFS did not finalize its written procedures for accounting for certain program transactions, preparing its September 30, 2009, financial statements, and overseeing and monitoring financial-related services asset managers and financial agents provided to OFS. Further, OFS did not have proper segregation of duties over a significant accounting database it used in valuing its assets in that the same individual was responsible for performing both the data entry and the reconciliation of the data output. However, OFS had developed and implemented other controls over TARP transactions and activities that reduced the risk of material misstatements resulting from these deficiencies.

Financial Statements Review and Approval Process

OFS did not effectively implement its review and approval process for preparing its fiscal year 2009 financial statements and related disclosures for TARP. While OFS had draft procedures for the preparation of year-end financial statements and performed year-end review and approval processes, we identified incorrect amounts and inaccurate, inconsistent, and incomplete disclosures in OFS's draft financial statements, footnotes, and Management's Discussion and Analysis (MD&A) for TARP that were significant, but not material, and that were not detected by OFS. Office of Management and Budget (OMB) Circular No. A-136, *Financial Reporting Requirements*,¹¹ requires agencies to ensure that

¹⁰OFS accounts for its equity investments at fair value, defined as the estimated amount of proceeds OFS would receive if the equity investments were sold to a market participant. OFS derives fair value measurements by applying the provisions of Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, to account for TARP direct loans, equity investments, and asset guarantees. SFFAS No. 2 requires the measurement of certain assets at the net present value of the estimated future cash flows. OFS used economic and financial models to estimate future cash flows for TARP. The economic and financial models reflect specific terms and conditions of the program and financial instruments, technical assumptions regarding the underlying assets, risk of loss, and other factors, as appropriate.

¹¹OMB Circular No. A-136, *Financial Reporting Requirements* (Revised June 2009), establishes a central point of reference for federal financial reporting guidance for executive branch agencies required to submit audited financial statements.

information in the financial statements is presented in accordance with GAAP for federal entities. Without an effectively implemented review and approval process for preparing financial statements and related disclosures, an agency is at risk of presenting information that is inaccurate, incomplete, or not in conformity with GAAP.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the Chief Financial Officer (CFO) to establish a mechanism for the effective implementation of the review and approval process for preparing the year-end financial statements and related disclosures, including MD&A, for TARP.

Procedures for Accounting and Financial Reporting

OFS had developed and implemented written procedures related to many of its accounting and financial reporting processes, such as disbursement and receipt processing and asset valuation. However, OFS had not finalized other procedures related to its processes for accounting for certain program transactions, preparing its September 30, 2009, financial statements, and its oversight and monitoring of financial-related services provided to OFS by asset managers and certain financial agents. As detailed below, procedures were not finalized either because they were in draft form, did not address certain specific issues, or had not yet been developed.

*Standards for Internal Control in the Federal Government*¹² provides that agencies should establish internal controls for all transactions and other significant events and that these transactions should be clearly documented, and the documentation should be readily available for examination. It further provides that documentation should appear in management directives, administrative policies, or operating manuals. The 10 accounting and financial reporting areas in which OFS did not fully comply with these provisions, along with certain other applicable guidance, relate to:

- modifications of direct loans, equity investments, and asset guarantees;
- subsequent events;
- contractor's economic and financial model review findings;
- economic and financial model error and warning messages;
- economic and financial model assumptions derived from informed opinion;
- interest, dividends, and distributions receivable;
- preparing financial statements;
- asset manager data used in the asset valuation process;

¹²GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999), contains the internal control standards to be followed by executive agencies in establishing and maintaining systems of internal control as required by 31 U.S.C. § 3512 (c), (d) (commonly referred to as the Federal Managers' Financial Integrity Act of 1982).

- oversight of HAMP financial agents; and,
 - estimating the HAMP liability.
- **Modifications of direct loans, equity investments, and asset guarantees.** Although OFS performed steps to identify and evaluate modifications (government actions, such as a change in contract terms, that alter the cost of a program),¹³ OFS did not have specific written procedures necessary to help ensure complete, accurate, and consistent identification and evaluation of modifications of direct loans, equity investments, and asset guarantees. Personnel from OFS's Office of Credit Modeling and Analysis (OCMA) conducted informal discussions with personnel from OFS's Office of the Chief Investment Officer (OCIO) to obtain information on asset-related events that could be modifications, such as amendments to contracts. While OCMA relied on OCIO to help identify potential modifications, OFS lacked specific written procedures to define OCIO and OCMA roles and responsibilities and criteria for OCIO and OCMA to use to help ensure comprehensive, accurate, and consistent identification and evaluation of such events. In addition, OFS lacked specific written procedures requiring documentation of management review and approval, and OMB approval, of the modification subsidy cost estimate. However, OFS did maintain documentation of the nature of the modifications, the cost of the modifications, and OMB's approval.

The Federal Accounting Standards Advisory Board's (FASAB), *Federal Financial Accounting and Auditing Technical Release 6 (Technical Release 6)*,¹⁴ calls for management to ensure that documentation is available for modifications, including the review and approval process of the modification subsidy cost estimate and the sign-off procedure within the agency. The lack of written procedures for the identification and evaluation of modifications increases the risk that all modifications are not timely identified, evaluated, and described in the financial statements and related disclosures.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to develop and implement written procedures for identifying and evaluating modifications of direct loans, equity investments, and asset

¹³According to OMB Circular No. A-11 §185, *Preparation, Submission, and Execution of the Budget*, (Revised November 2009), the term "modification" means a federal government action, including new legislation or administrative action that directly or indirectly alters the estimated subsidy cost and the present value of the asset. There are situations where it is not clear whether a government action constitutes a modification. These situations should be judged on a case-by-case basis by OMB in consultation with the agency involved. Agencies must have budget authority available to cover the cost of a modification that increases the subsidy cost before the modification takes place.

¹⁴Federal Accounting Standards Advisory Board, *Federal Financial Accounting and Auditing Technical Release 6: Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act – Amendments to Technical Release No. 3 Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act* (January 2004).

guarantees, to include: specific roles and responsibilities, criteria to identify modifications, documentation of management review and approval, and documentation of OMB approval of the modification subsidy cost estimate.

- **Subsequent events.** OFS did not have written procedures to identify and evaluate subsequent events¹⁵ that could require revisions to its asset valuations or additional disclosures in the notes to its financial statements. After OFS's year-end, but before OFS issued its financial statements, we identified certain subsequent events that could have affected asset valuations and financial statement disclosures. At our request, OFS developed and implemented draft procedures to identify and evaluate the effect on OFS's asset valuation of the failure, such as a bankruptcy, of a TARP participant subsequent to year-end. As a result of implementing these procedures, OFS revised certain asset valuations and added additional disclosures to its financial statements.¹⁶ However, a lack of finalized procedures for consideration of subsequent events in the asset valuation process increases OFS's risk of not consistently following procedures from period to period and risk of misstatements and insufficient disclosures.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to finalize and implement OFS's draft written procedures for identifying and evaluating any subsequent events that could have an effect on asset valuations and related disclosures.

- **Contractor's economic and financial model review findings.** OFS did not have written procedures for formally tracking the resolution of findings from independent verification and validation reviews of its economic and financial models used for valuing TARP direct loans, equity investments, and asset guarantees. OFS hired a contractor to perform an independent verification and validation of the technical accuracy of OFS's economic and financial models. The contractor provided OFS reports that summarized its review procedures and findings, including potential errors that could affect the models' calculations. Although OFS provided information on actions taken to address the contractor's findings, OFS did not have documentation linking the actions to the findings and showing the resolution of each of the contractor's findings. Consequently, OFS faces an increased risk that model errors were not appropriately resolved. Unresolved errors in the economic and financial

¹⁵According to SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, subsequent events are events or transactions that occur subsequent to the balance sheet date but prior to the issuance of the financial statements and auditor's report that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements.

¹⁶According to AU Section 560.07, *Subsequent Events* (American Institute of Certified Public Accountants *Professional Standards*), subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements because such events typically represent the culmination of conditions that existed over a relatively long period of time.

models increase the risk that the direct loans, equity investments, and asset guarantees may be misstated in the financial statements.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to develop and implement written procedures for tracking the resolution of independent verification and validation findings related to OFS's economic and financial models used for valuing TARP direct loans, equity investments, and asset guarantees.

- **Economic and financial model error and warning messages.** OFS's written asset valuation procedures did not include specific steps for the identification, resolution, and documentation of error and warning messages produced by the economic and financial models used for valuing TARP direct loans, equity investments, and asset guarantees. The error and warning messages produced by the economic and financial models alert OFS personnel of potential issues with the model calculations or data. While OFS provided reasonable explanations concerning the resolution of the economic and financial model error and warning messages, OFS did not document these resolutions. Any unresolved errors in the economic and financial models increase the risk that the valuation of direct loans, equity investments, and asset guarantees may be misstated in the financial statements.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to update existing procedures to include procedures for identifying and resolving economic and financial model error and warning messages, including requirements to maintain appropriate supporting documentation regarding the resolution of such instances.

- **Economic and financial model assumptions derived from informed opinion.** OFS's written asset valuation procedures did not include requirements for documenting the use of assumptions derived from informed opinion¹⁷ and OFS did not sufficiently document its basis for certain assumptions derived from informed opinion. As part of OFS's valuation of TARP direct loans, equity investments, and asset guarantees and consistent with FASAB guidance, OFS used informed opinion to make certain assumptions for use in its economic and financial models. Although OFS's asset valuation procedures provided that documentation must discuss all significant assumptions and why assumptions were selected, OFS's asset valuation procedures did not specifically require documentation for the use of assumptions derived from informed opinion. In addition, although OFS

¹⁷Informed opinion refers to the judgment of agency staff or others who make subsidy estimates based on their programmatic knowledge, experience, or both. Informed opinion is considered an acceptable approach under *Technical Release 6* when adequate historical data does not exist.

documented the assumptions it used in its economic and financial models and met with senior officials to review the assumptions and obtain the officials' approval, OFS did not sufficiently document the basis for certain assumptions derived from informed opinion. For example, in its valuation of direct loans, OFS used informed opinion as a basis for its assumptions of recoveries on defaulted loans. Although OFS documented its recovery assumption values, it did not sufficiently document the basis for the opinion on the assumption values. In another instance, OFS used informed opinion as a basis for its assumption related to expected prepayments from TARP participants. However, OFS did not adequately document the basis for the informed opinion. In both cases, while the opinions were not adequately documented, OFS was able to sufficiently explain the basis for its opinions.

FASAB *Technical Release 6* states that documentation be provided to support the assumptions used by the agency in the subsidy calculations to facilitate the agency's review of the assumptions. The documentation should be complete such that a knowledgeable independent person could perform the same steps and replicate the same results with little or no outside explanation or assistance. In addition, FASAB *Technical Release 6* calls for the basis of the stated opinion to be articulated and documented in detail when informed opinion is used. The absence of sufficient supporting documentation of the basis for certain economic and financial model assumptions derived from informed opinion may impair management's ability to effectively oversee and approve assumptions, which increases the risk of misstatements due to valuation errors.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to update OFS's asset valuation procedures to include specific requirements for documenting the basis of economic and financial model assumption values derived from informed opinion consistent with FASAB *Technical Release 6*.

- **Interest, dividends, and distributions receivable.** OFS did not have written procedures on how income from direct loans and trust preferred securities should be presented on the Statement of Net Cost, and on how accrued interest receivable, dividends declared but unpaid, and distributions receivable should be disclosed in notes to OFS's financial statements for TARP.¹⁸ OFS also did not have written procedures for the identification of dividends declared but unpaid as of September 30, 2009.

¹⁸Under multiple TARP programs, OFS held direct loans, equity investments, and trust preferred securities. Direct loans accrue interest and equity securities generally entitle OFS to receive periodic dividends if and when dividends are declared by the corresponding issuer of the securities. Trust preferred securities generally entitle OFS to receive certain distributions consistent with the terms of the financial instruments held by the corresponding trust.

As of September 30, 2009, OFS had interest receivable relating to certain direct loans and considered the future cash flows relating to expected interest payments in valuing its direct loans.¹⁹ OFS evaluated how to present and disclose certain interest-related accounts. However, OFS did not have written procedures on how to present interest income on direct loans in the Statement of Net Cost and disclose any accrued interest receivable in the notes to its financial statements. According to OMB Circular A-136, management's method for accruing interest revenue and recording interest receivable should be disclosed. Also, this circular calls for interest receivable to be reported as a component of direct loans in the notes to the financial statements. OFS did not disclose any accrued interest because it determined that the accrued interest receivable as of September 30, 2009, was not significant.

Similarly, OFS considered future cash flows relating to expected dividends from equity securities and expected distributions receivable from trust preferred securities in valuing such investments. FASAB standards for credit reform accounting do not contain guidance as to the presentation in the Statement of Net Cost and disclosure in the notes to the financial statements of dividends declared but unpaid and distributions receivable from trust preferred securities. In the absence of any federal guidance, OFS disclosed in the notes to its financial statements that it presents in its Statement of Net Cost dividend revenue when dividends are declared. OFS had not, however, developed written procedures regarding presentation of income from trust preferred securities in the Statement of Net Cost. Further, although OFS took specific steps to determine whether there were any dividends declared but unpaid as of September 30, 2009, OFS had not developed written procedures for (1) determining whether such items existed as of September 30, 2009, or (2) disclosing in the notes to the financial statements dividends declared but unpaid and, if applicable, distributions receivable.²⁰

Without written procedures regarding presentation and disclosure of the activity and balances discussed above, OFS faces an increased risk that the financial statements will contain misstatements or will lack adequate disclosures.

¹⁹OFS applies the provisions of Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, to account for TARP direct loans, equity investments, and asset guarantees. SFFAS No. 2 requires the measurement of certain assets at the net present value of the estimated future cash flows. OFS includes future dividends and interest in its cash flow estimates.

²⁰OFS performed procedures and concluded that there were no significant dividends declared but unpaid as of September 30, 2009.

Recommendations for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to develop and implement written procedures for

- presenting income from direct loans and trust preferred securities in the Statement of Net Cost,
 - identifying any year-end dividends declared but unpaid to OFS from TARP participants, and
 - disclosing accrued interest receivable, dividends declared but unpaid, and, if applicable, distributions receivable from trust preferred securities in OFS's financial statements for TARP.
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- **Preparing financial statements.** OFS had not finalized its draft procedures for the preparation of the year-end financial statements or included in its draft procedures all key processes used in the preparation of the year-end financial statements. While OFS performed year-end financial statement processes, OFS's written procedures governing those processes were in varying states of completion. For example, the processes OFS used in preparing its financial statements, recording adjusting journal entries after the close of the general ledger, reconciling general ledger balances, and identifying any commitments and contingencies were not included in OFS's draft procedures for financial reporting. OMB Circular No. A-136 provides that each agency CFO should establish procedures guiding agency fiscal and management personnel on how to prepare annual financial statements. Without finalized financial reporting processes, OFS faces increased risk that the financial statements will contain misstatements or inadequate disclosures.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to finalize and implement procedures for the preparation of the year-end financial statements to include all key preparation processes.

- **Asset manager data used in the asset valuation process.** While OFS carried out oversight and monitoring activities, OFS did not have written procedures detailing how it is to oversee and determine the reasonableness of the data provided by asset managers and used for OFS's internally developed TARP asset valuations. OFS contracted external asset managers to provide, among other things, independently performed asset valuations and credit scores²¹ for each institution. OFS performed specific steps to help ensure consistency in the methodology applied by the asset managers in preparing their asset valuations. OFS also analyzed the aggregate valuations and credit

²¹The asset managers' credit scores are based on assessments of the capital adequacy, asset quality, earnings, and liquidity of each financial institution and represent a forward-looking risk of failure, which correlates to the likelihood of repayment of TARP funds.

score data provided by the asset managers and explained how information was used by the asset managers. However, OFS did not provide documentation of oversight steps performed to determine that the information provided by the asset managers was reasonable before using the data in its valuation process. In addition, in connection with OFS's use of the asset manager valuations to assess the reasonableness of its internal asset valuations of preferred share equity investments, OFS investigated differences between OFS's valuations and those of the asset managers that exceeded a certain threshold. However, OFS did not document the rationale for the threshold selected. Without written procedures for overseeing and assuring the reasonableness of asset manager-provided data, the risk that misstatements due to valuation errors may not be prevented or detected and corrected on a timely basis is increased.

Recommendations for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO

- in coordination with the Chief Investment Officer, to develop and implement, as part of OFS's oversight and monitoring activities, written procedures detailing steps to effectively oversee and determine the reasonableness of data provided by external asset managers, prior to the use of such data, and
 - to develop and implement written procedures to document the rationale for established thresholds used in determining whether to investigate differences between the asset manager valuations and OFS's internally developed asset valuations.
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- **Oversight of HAMP financial agents.** OFS did not have written procedures for the oversight and monitoring of its financial agents'—Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac)—administrative and compliance activities, including internal controls over existence and completeness of loan data used in determining the HAMP liability. OFS contracted with Fannie Mae to act as the program administrator and record keeper of loan data for HAMP and with Freddie Mac to perform compliance activities related to HAMP servicers.²² Without clearly documented guidance regarding the specific procedures OFS should follow to effectively oversee and monitor Fannie Mae and Freddie Mac, OFS faces an increased risk that the financial information related to HAMP may not be complete or correct, and OFS management's ability to identify key risks in this area may also be impaired. While OFS disbursed less than \$1 million during fiscal year 2009 for HAMP, the importance of having written procedures in these areas will become more significant as HAMP activity increases.

²²Under HAMP, Treasury enters into contracts with servicers—financial institutions that commit to modify mortgages and to receive and make payments in accordance with specified criteria.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to develop and implement written procedures detailing steps to be performed in overseeing and monitoring OFS's financial agents, Fannie Mae and Freddie Mac, including internal controls over the existence and completeness of loan data used in the determination of the HAMP liability.

- **Estimating the HAMP liability.** OFS did not have written procedures for estimating the HAMP liability. The HAMP liability represents the liability for payments to servicers and investors and principal balance reduction payments for the benefit of borrowers under HAMP. OFS developed a position paper setting out an approach for estimating the HAMP liability in accordance with SFFAS No. 5, *Accounting for Liabilities in the Federal Government*. However, OFS did not document the specific procedures it used in estimating the HAMP liability. Without such written procedures, there is an increased risk that liability amounts will be calculated incorrectly. As of September 30, 2009, the HAMP liability was less than \$2 million; however, the importance of having written procedures in this area will become more significant as HAMP activity increases.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to develop written procedures for periodically estimating the HAMP liability.

Segregation of Duties

OFS did not have proper segregation of duties over a significant accounting database it uses in valuing certain of its assets. OFS maintained an accounting database of information that it used for multiple purposes, including as a source for certain data that were input into economic and financial models used for the valuation of TARP direct loans, equity investments, and asset guarantees. OFS recorded in the accounting database certain institution and transaction-specific information, such as the name of the institution, the dollar value of a transaction, and the type of financial instrument²³ involved in the transaction. However, the same individual was responsible for performing both the data entry and the reconciliation of the data output.

Specifically, the same OFS staff member performed the incompatible duties of recording information into the accounting database, comparing information

²³Financial instruments include preferred stock, common stock, warrants for the purchase of common stock, and subordinated debentures.

between the accounting database and reports from the TARP custodian,²⁴ recording changes in the accounting database, and reconciling information between the accounting database and the OFS general ledger.

Consistent with *Standards for Internal Control in the Federal Government*, key duties and responsibilities are to be divided or segregated among different individuals to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, and reviewing the transactions. No one individual should control all key aspects of a transaction or event. Without adequate segregation of duties over the accounting database, OFS faces an increased risk that error or fraud related to asset valuation information may occur and not be detected and corrected on a timely basis.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to develop and implement procedures to segregate the responsibilities for recording, approving, and reconciling of information maintained in the accounting database used by OFS in the asset valuation process.

Verification Procedures over the Data Used for Asset Valuations

OFS did not effectively implement verification procedures for certain assumptions and data that were input into the economic and financial credit subsidy models used for the valuation of TARP direct loans, equity investments, and asset guarantees. OFS accounts for TARP direct loans, equity investments, and asset guarantees consistent with the concepts in SFFAS No. 2, *Accounting for Direct Loans and Loan Guarantees*. SFFAS No. 2 requires agencies to value certain assets at the net present value of estimated future cash flows. Further, *Standards for Internal Control in the Federal Government* provides that control activities help to ensure that all transactions are completely and accurately recorded. To estimate cash flows for TARP, OFS developed economic and financial models that use data files, which include information related to the actual terms of the instruments and the financial condition of the institutions, as well as assumptions about future performance. OFS used automated data inputs and a significant number of manual inputs to create these data files. The use of manual inputs poses an increased inherent risk of error, and therefore effective review procedures are needed to reduce such risk.

OFS's established verification procedures related to the valuation of TARP direct loans, equity investments, and asset guarantees called for OFS analysts to verify and document that the data files accurately reflect the data used in the valuation process. However, these procedures lacked specificity with respect to the steps to follow in the review of manual inputs that are used in the economic and financial

²⁴Bank of New York Mellon (BNYM) functions as the TARP custodian by, among other things, taking possession of stock certificates, storing agreements, and generating reports related to TARP transactions.

credit subsidy models. In our audit, we identified data input errors to the estimation models related to interest and dividend rates, maturity dates, other instrument-specific terms, and assumptions related to future performance. Many of the significant errors we identified related to manual inputs. Significant errors that we identified were corrected and amounts were properly reflected in the September 30, 2009, financial statements. OFS did perform procedures to assess the reasonableness of the model outputs, including comparison of the asset valuations calculated by the model with independently performed valuations. These procedures reduced the risk that management would not detect misstatements resulting from the data input errors.

However, the lack of effective verification of data inputs used in the economic and financial credit subsidy models increases the risk that the asset valuations and related subsidy cost are not completely and accurately recorded and reliably reported in the financial statements.

Recommendations for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to

- enhance and implement specific written procedures to verify data inputs, including manual inputs, used in the economic and financial models for the valuation of TARP direct loans, equity investments, and asset guarantees, and help ensure that such verification is clearly documented, and
- assess manual inputs used in the economic and financial models for the valuation of TARP direct loans, equity investments, and asset guarantees to determine the feasibility of reducing the number of manual inputs.

Other Control Deficiencies

In addition to the two significant deficiencies, we identified other control deficiencies that were not considered material weaknesses or significant deficiencies, but nevertheless warrant OFS management's attention and action. Specifically, as discussed in the following sections, we identified deficiencies concerning OFS controls over

- tracking executed agreements,
- recording warrant transactions, and
- reconciliations of disbursements to and refunds from the TARP custodian.

Tracking Executed Agreements

OFS lacked a mechanism for tracking the location of TARP executed agreements including securities purchase agreements for TARP investments. OFS's contract with the Bank of New York Mellon (BNYM) established that BNYM is to retain executed agreements and related legal documentation at a secure facility.

According to OFS officials, after agreements were executed, OFS's legal agents sent executed agreements and related legal documentation to the BNYM repository, and BNYM was then responsible for reviewing, sorting, and securely storing the documents. However, OFS did not have a mechanism for tracking the location of TARP executed agreements. Our tests revealed that OFS could not readily locate three agreements. However, in following up on our tests, OFS ultimately found that the agreements in question were held by OFS's legal agents.

Standards for Internal Control in the Federal Government provides that an agency is to establish physical control to secure and safeguard vulnerable assets. In addition, access to resources and records should be limited to authorized individuals, and accountability for their custody and use should be assigned and maintained. Without a mechanism for reliably tracking the location of TARP executed agreements and related legal documentation, the records are at risk of loss.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the appropriate personnel to develop, document, and implement a mechanism to track the location of executed agreements.

Recording Warrant Transactions

OFS did not have written procedures for recording warrant adjustments²⁵ and did not properly record certain warrant transactions in the accounting database used for valuing TARP assets.

The warrant terms stipulate that if a TARP participant declares and pays a stock dividend,²⁶ the number of shares underlying the warrant and the price per share is to be adjusted so that Treasury is entitled to purchase the number of shares of common stock that it would have been entitled to receive at the exercise price had Treasury exercised the warrant immediately prior to the effective date²⁷ of the adjustment. However, for the purpose of recording warrant adjustments related to stock dividends in the accounting database, OFS incorrectly used the date the shares were distributed to common shareholders, rather than the effective date of the warrant adjustment. We also found that OFS did not properly record in the accounting database certain other warrant adjustments resulting from events that occurred prior to September 30, 2009. Generally, if a TARP participant in the

²⁵ A warrant is an option to buy shares of common stock or preferred stock at a predetermined price (i.e., exercise price) on or before a specified date. A warrant adjustment is a change to the exercise price, the number of shares underlying the warrant, or both because of various events such as stock splits and stock dividends.

²⁶ A stock dividend is the payment of a dividend on an entity's shares of common stock in the form of additional shares of common stock rather than in cash.

²⁷ The effective date would be the ex-dividend date, which is the date on which a transaction, such as a stock dividend, is effective for the party holding the security on that date.

Capital Purchase Program issued qualified stock prior to December 31, 2009, the number of shares underlying the warrant was to be reduced by half. However, we found that OFS did not always properly record in the accounting database the transactions to reduce these warrants by half. These errors in OFS's warrant records, although not significant, nonetheless resulted in misstatements in OFS's financial statements for TARP.

Standards for Internal Control in the Federal Government provides that agencies should have controls in place to provide reasonable assurance that financial transactions are recorded completely and accurately and that internal control be clearly documented in management directives, administrative policies, or operating manuals. Without effective procedures to reasonably ensure that warrant adjustments are properly recorded, OFS faces an increased risk of undetected misstatements of the related TARP assets.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to develop and implement written procedures specifying detailed steps to be followed to reasonably ensure that warrant adjustments are properly recorded in the accounting database OFS uses for valuing TARP assets.

Reconciliations of Disbursements to and Refunds from the TARP Custodian

OFS did not always document reconciliations of key documents for disbursements to and refunds from BNYM, the TARP custodian, and did not have an effective monitoring process to identify instances where such reconciliations were not documented. As part of OFS's disbursement process, BNYM disbursed funds received from OFS to individual TARP participants. OFS's written procedures require OFS personnel to reconcile the resulting key documents, such as the disbursement authorization, payment system voucher, and the BNYM confirmation notice of funds received. Although OFS documented its reconciliations in certain instances and maintained records of the key documents used in the disbursement process, OFS did not always document such reconciliations as required. OFS disburses funds to BNYM based on its expectation of the transactions with TARP participants scheduled to occur on a particular day. However, in some instances, certain transactions are not completed on the scheduled day and BNYM refunds the corresponding amounts to OFS. OFS also did not always document reconciliations related to refunds from BNYM as required.

Standards for Internal Control in the Federal Government specifies that control activities include approvals, authorizations, verifications, reconciliations, and the creation and maintenance of related records that provide evidence of the execution of these activities as well as appropriate documentation. Although our tests did not identify any errors in amounts disbursed or refunded, by not always following established procedures for the documentation of disbursement- and

refund-related reconciliations, OFS faces an increased risk that it will not timely detect any incorrect disbursements to or refunds from BNYM.

Recommendation for Executive Action

We recommend that the Assistant Secretary for Financial Stability direct the CFO to establish procedures to effectively monitor the documentation of reconciliations of key documents related to disbursements to and refunds from BNYM as prescribed in OFS's written procedures.

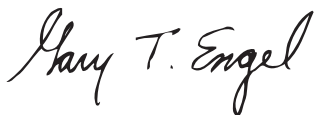
Agency Comments

In commenting on a draft of this report, the Assistant Secretary for Financial Stability stated that OFS concurred with the recommendations in our draft report. The Assistant Secretary also stated that OFS began taking actions related to these recommendations in January 2010 following the release of our audit report and expects to have implemented corrective actions for all recommendations by September 30, 2010. We plan to follow up to determine the status of corrective actions taken for these matters during our fiscal year 2010 audit.

This report is intended for use by OFS management. We are sending copies of this report to interested congressional committees and members, the Secretary of the Treasury, Inspector General of the Department of the Treasury, Special Inspector General for TARP, Congressional Oversight Panel, Financial Stability Oversight Board, Director of the Office of Management and Budget, and others. In addition, this report is available at no charge on GAO's Web site at <http://www.gao.gov>.

We acknowledge and appreciate the cooperation and assistance provided by OFS management and staff during our audit of OFS's fiscal year 2009 financial statements for TARP. If you have questions about this report, please contact me at (202) 512-3406 or engelg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in enclosure II.

Sincerely yours,



Gary T. Engel
Director
Financial Management and Assurance

Enclosures - 2

Enclosure I: Comments from the Office of Financial Stability



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 17, 2010

Mr. Gary T. Engel
Director, Financial Management and Assurance
U.S. Government Accountability Office

Dear Mr. Engel:

We have received a copy of your draft report entitled *Management Report: Improvements Are Needed in Internal Control Over Financial Reporting for the Troubled Asset Relief Program* (GAO-10-743R).

We are pleased that you noted in your report that the Office of Financial Stability received unqualified opinions on both the OFS FY 2009 financial statements and internal control over financial reporting and had no identified instances of noncompliance with selected provisions of laws and regulations.

We have reviewed the detailed recommendations that you have provided regarding the two significant deficiencies you identified during your FY 2009 audit and regarding the other less significant control deficiencies. We concur with your draft recommendations.

Through coordination with your staff and our understanding of the Matters for Further Consideration that we responded to during the FY 2009 audit, we began taking action on the recommendations in January 2010 immediately after your final audit report was released. We have made the necessary improvements to our processes and procedures. We expect to implement the majority of other necessary changes by June 30, 2010 and any remaining changes by September 30, 2010.

Sincerely,

A handwritten signature in black ink that reads "Herbert M. Allison, Jr." with a stylized flourish at the end.

Herbert M. Allison, Jr.
Assistant Secretary
Office of Financial Stability

Enclosure II: Staff Acknowledgments

Acknowledgments

The following individuals made major contributions to this report: Marcia L. Carlsen, Lynda E. Downing, and Joseph P. O'Neill, Assistant Directors; Janaya D. Davis-Lewis, Vincent Gomes, Diane M. Koch, Steven M. Koons, Mary V. Osorno, Grant L. Simmons, Anne Y. Sit-Williams, and Chris G. Yfantis.

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