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## Report of Independent Auditors

The Secretary and the Inspector General of the  
U.S. Department of Health and Human Services

### **Report on the Financial Statements**

We have audited the accompanying consolidated balance sheets of the U.S. Department of Health and Human Services (HHS) as of September 30, 2016 and 2015, and the related consolidated statement of net cost and changes in net position, and the combined statement of budgetary resources for the fiscal years then ended, and the related notes to the principal financial statements. We were also engaged to audit the statement of social insurance as of January 1, 2016, 2015, 2014, 2013, and 2012, the related statement of changes in social insurance amounts for the periods ended January 1, 2016 and 2015, and the related notes to these financial statements.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

Our responsibility is to express opinions on these financial statements based on our audits. Except as discussed in the Basis for Disclaimer of Opinion paragraphs with respect to the accompanying statement of social insurance as of January 1, 2016, 2015, 2014, 2013, and 2012, the related statement of changes in social insurance amounts for the periods ended January 1, 2016 and 2015, and the related notes to these financial statements, we conducted our audits in accordance with auditing standards generally accepted in the United States, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*. Those standards and bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to HHS's preparation and fair presentation of the financial statements in order to design

audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the consolidated balance sheets as of September 30, 2016 and 2015, and the related consolidated statement of net cost and changes in net position, and the combined statement of budgetary resources for the fiscal years then ended, and the related notes to the principal financial statements.

***Basis for Disclaimer of Opinion on the Statement of Social Insurance and the Related Changes in the Social Insurance Program***

As discussed in Note 24 to the principal financial statements, the statement of social insurance presents the actuarial present value of the Hospital Insurance (HI) and Supplementary Medical Insurance (SMI) trust funds' estimated future income to be received from or on behalf of the participants and estimated future expenditures to be paid to or on behalf of participants during a projection period sufficient to illustrate long-term sustainability of the social insurance program. In preparing the statement of social insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statement. Because of the large number of factors that affect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material. Projections of Medicare costs are sensitive to assumptions about future decisions by policymakers and about the behavioral responses of consumers, employers, and health care providers as policies, incentives, and the health care sector change over time. In addition to the inherent variability that underlies the expenditure projections prepared for all parts of Medicare, and as discussed below, significant additional variability and issues regarding the sustainability of the underlying assumptions under current law were introduced by the passage of the Patient Protection and Affordable Care Act (ACA) and the Medicare Access and CHIP Reauthorization Act (MACRA).

As further described in Note 25 to the principal financial statements, with respect to the estimates for the social insurance program presented as of January 1, 2016, 2015, 2014, 2013, and 2012, management has assumed in the projections of the program that the various cost-reduction measures will occur as the ACA and the specified physician updates established by MACRA require. Management has developed an illustrative alternative scenario and projections intended to quantify the potential understatement of projected Medicare costs to the extent that certain payment provisions were not fully implemented in all future years. The range of the social insurance liability estimates in the scenarios is significant. As described in Note 25, the ability of health care providers to sustain these price reductions will be challenging, as the best available

evidence indicates that most providers cannot improve their productivity to this degree for a prolonged period given the labor-intensive nature of these services. As a result, actual Medicare expenditures are highly uncertain for reasons apart from the inherent difficulty in projecting health care cost growth over time. Absent an unprecedented change in health care delivery systems and payment mechanisms, the prices paid by Medicare for most health services will fall increasingly short of the costs of providing these services. For example, overriding the scheduled physician payment updates or the productivity adjustments for most providers, as was done repeatedly with the sustainable growth rate formula in the period leading up to passage of MACRA and may be necessary in the future if cost rates prove inadequate, would lead to substantially higher costs for Medicare in the long range than those projected in this report. As a result of these limitations, we were unable to obtain sufficient audit evidence for the amounts presented in the statement of social insurance as of January 1, 2016, 2015, 2014, 2013, and 2012, and the related statement of changes in social insurance amounts for the periods ended January 1, 2016 and 2015.

***Disclaimer of Opinion on the Statement of Social Insurance and the Related Changes in the Social Insurance Program***

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial condition of the HHS social insurance program as of January 1, 2016, 2015, 2014, 2013, and 2012, and the related changes in the social insurance program for the periods ended January 1, 2016 and 2015.

***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of HHS as of September 30, 2016 and 2015, and its consolidated net cost, changes in net position, and budgetary resources for the years then ended in conformity with U.S. generally accepted accounting principles.

**Other Matters**

***Required Supplementary Information***

U.S. generally accepted accounting principles require that the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information as identified on HHS's Agency Financial Report Table of Contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Federal Accounting Standards Advisory Board, which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards

generally accepted in the United States, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

### ***Other Financial Information and Other Information***

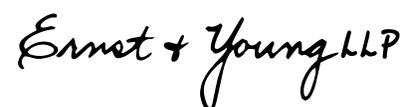
Our audits were conducted for the purpose of forming opinions on the financial statements that collectively comprise HHS's basic financial statements. The Other Financial Information, as identified on HHS's Agency Financial Report Table of Contents, is presented for purposes of additional analysis and is not a required part of the basic financial statements.

The Other Financial Information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States. In our opinion, the Other Financial Information is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

Except for the Other Financial Information described above, the Other Information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and, accordingly, we do not express an opinion or provide any assurance on it.

### ***Other Reporting Required by Government Auditing Standards***

In accordance with *Government Auditing Standards*, we also have issued our reports dated November 14, 2016, on our consideration of HHS's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* in considering HHS's internal control over financial reporting and compliance.



November 14, 2016



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## Report of Independent Auditors on Internal Control over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

The Secretary and the Inspector General of the  
U.S. Department of Health and Human Services

We have audited, in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*, the consolidated financial statements of the U.S. Department of Health and Human Services (HHS or the Department), which comprise the consolidated balance sheet as of September 30, 2016, and the related consolidated statement of net cost and changes in net position, and the combined statement of budgetary resources for the fiscal year then ended, and the related notes to the principal financial statements, and we were engaged to audit the statement of social insurance as of January 1, 2016, and the related statement of changes in social insurance amounts for the period ended January 1, 2016, and have issued our report thereon dated November 14, 2016. That report states that because of the matters described in the Basis for Disclaimer of Opinion paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the statement of social insurance as of January 1, 2016, and the related statement of changes in social insurance amounts for the period ended January 1, 2016.

### **Internal Control over Financial Reporting**

In planning and performing our audit of the financial statements, we considered HHS's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of HHS's internal control. Accordingly, we do not express an opinion on the effectiveness of HHS's internal control. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 15-02. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*, such as those controls relevant to ensuring efficient operations.

*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. A *material weakness* is a deficiency, or a 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 *significant deficiency* is a deficiency, or a 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies; therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit, we did identify certain deficiencies related to Financial Information Systems, described below, to be a material weakness. We also identified certain deficiencies related to Financial Reporting Systems, Analyses, and Oversight, and National Institutes of Health (NIH) Financial Management Systems and Review Processes, described below, to be significant deficiencies.

## **Material Weakness**

### ***Financial Information Systems***

The Department continued to make strides during fiscal year (FY) 2016 to improve the controls within its supporting information technology (IT) infrastructure and financial systems. The Material Weakness Working Group (MWWG) has continued to take a leadership role in monitoring remediation activities across all IT systems in scope of the consolidated Financial Statement Audit and *Federal Information Security Modernization Act of 2014* (FISMA). The MWWG has effectively altered the culture and “tone at the top” by putting a heightened focus on addressing the root cause of issues identified during the audit, resulting in a more mature controls environment across the Department. The following summarizes some of the improvements achieved that resulted from this increased attention:

- Differential investments in key financial systems’ underlying infrastructure (i.e., Oracle upgrades and movement to the cloud), providing a more modern and mature controls baseline that positions the Department well for future scalability in an efficient manner;
- Proactive remediation of issues identified during the audit, allowing for the residual risk of the issue to be minimized, while establishing the processes necessary to close the issue moving forward; and
- Strengthening of the Department-wide Plan of Actions and Milestone (POA&M) process, which has led to the remediation of a number of prior year objective attributes recap sheet (OARS) items.

Although the MWWG has implemented specific action plans to decrease the number and severity of the deficiencies remaining in the major financial systems, the remediation of deficiencies, which sometimes takes multiple years, is inherently an iterative process. A focused risk-driven effort is still necessary to completely remediate the remaining long-outstanding deficiencies in the areas of

access controls, configuration management, and segregation of duties (SOD). The remaining deficiencies continue to constitute an IT material weakness in internal control. We grouped the deficiencies into the following topics and categories listed below:

- Access controls
  - Inconsistently performing user access reviews of generic IDs, some with administrative access, which impacts the ability to effectively identify and monitor access anomalies and other potentially suspicious activities
  - Users maintaining multiple user IDs to the application and/or users with excessive application access that is not commensurate with their job roles and responsibilities
- Configuration management
  - Understanding the full population of changes made to an application and verifying that no changes were made to a system that did not go through the change approval and management process
- Segregation of duties
  - Limited role-based security implementation and established policies and procedures supporting role-based security
  - Inconsistent implementation of least privileged access considerations for all users and limited documentation regarding business justifications for identified SOD conflicts

The following is a summary of the deficiencies that we considered most critical. When we assess the deficiencies in aggregate, we continue to conclude they could have a material effect on the financial statements, and as a result, this forms the basis for our conclusion of an IT material weakness:

- Access controls – We identified access controls exceptions across eight of the nine applications in scope of our review, which spanned HHS and NIH. Specifically, we noted (1) audit logs are used to monitor user access and activity, but the audit logs are not reviewed/monitored on a consistent basis, (2) user activity is not consistently reviewed for suspicious or malicious activity, (3) shared user IDs, some with privileged access, are used without monitoring user activity performed when using the shared IDs in question, (4) allowing the use of multiple user IDs creates the risk of individuals performing activities that may violate segregation of duties, and (5) several systems had issues identified within the new user provisioning process to include an incomplete set of roles identified for access provisioning forms, and access being provisioned prior to receipt of required approvals. Similarly, the Centers for Medicare & Medicaid Services (CMS) did not perform or adequately perform management reviews of user access and system parameters for key financially significant applications. In addition, procedures for adding or removing users were not consistently followed.
- Configuration management – We identified configuration management exceptions in seven of the nine applications in scope of our review, which spanned HHS and NIH. Specifically,

we noted (1) configuration management and release management standard operating procedures were not developed or implemented across the span of the audit, (2) applications are not maintaining updated baseline configurations for certain aspects of the application, to include back-end database and operating system, and (3) we were not able to validate the full population of changes made to an application in order to verify that only changes that went through the change management and approval process were put into production. CMS continues to experience deficiencies in the implementation and monitoring of compliance with its defined computer security policies at both the Medicare fee-for-service contractors and the Central Office. Several vulnerabilities related to system configurations were identified with the Central Office and Medicare fee-for-service information systems. In several instances, the remediation, mitigation of risks, or monitoring of these vulnerabilities was not performed or not performed in a timely manner. In addition, evidence supporting the authorization and testing of claims processing software changes, application production support fixes, and infrastructure changes were not always retained and/or performed.

- Segregation of duties – We identified segregation of duties exceptions across four of our nine applications in scope of our review, which spanned HHS and NIH. Specifically, we noted (1) policies and procedures required to enforce segregation of duties among various roles have not been finalized and approved, (2) documented segregation of duties matrices have not been finalized by management and are still in draft form, (3) listing of all users with SOD conflicts and their respective business justifications is not proactively maintained, and (4) the use of multiple user IDs creates the risk of individuals performing functions that may violate SOD requirements. CMS continues to experience difficulties in implementing adequate segregation of duties. In addition, we identified users for two Central Office applications that were provided additional administrator rights.

## **Recommendations**

HHS should continue the focus achieved in FY 2016 to remediate the remaining deficiencies contributing to material weakness. The following are some specific considerations:

- Continue to identify, assess, modify, and monitor access controls, configuration management, and segregation of duties to further enhance the security posture of all applications. Specific recommendations for the non-CMS Operating Division (OpDiv) applications are included within the respective OARS for each application in scope.
- A focused effort should be made to decommission systems that are being planned to retire based on the implementation of the new system in which the Department is no longer making a differential investment in remediating the issues identified within the system.

- We have performed a separate financial statement audit of CMS for FY 2016 and, in conjunction with our reports on that audit, have provided recommendations specific to CMS on our IT internal control findings. Those findings and recommendations were considered in our overall HHS conclusions.

## **Significant Deficiencies**

### ***Financial Reporting Systems, Analysis, and Oversight***

Although progress in certain areas has been identified, HHS and its OpDivs' internal reviews and the results of our testing of internal control have continued to identify internal control deficiencies in financial systems and processes for producing financial statements, including lack of integrated financial management systems and insufficient analysis of certain significant accounts. In many cases, processes continued to be developed throughout FY 2016 and will require additional refinements in FY 2017 and beyond. Within the context of the approximately \$1 trillion in departmental net outlays, the ultimate resolution of our specific 2016 findings was not material to the consolidated financial statements taken as a whole. However, these matters are indicative of systemic issues that should continue to be resolved.

### ***Lack of Integrated Financial Management System***

Over the past 19 years, HHS has continued its efforts to overcome issues that have affected its ability to become compliant with the *Federal Financial Management Improvement Act of 1996* (FFMIA), including long-standing issues for which HHS and the audit have identified and reported in the past. For example:

- HHS records approximately \$1.1 trillion in manual journal entries to ensure balances within financial systems are correct.
- As discussed above, departures from requirements specified in OMB A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, and OMB A-130, *Management of Federal Information Resources*, related to access and change management controls within financial systems continue to be identified.
- The lack of sufficient integration within certain financial systems is not complemented with sufficient manual preventative and detective-type controls, including the NIH Business System (NBS), which continues to utilize two separate processes to report budgetary and financial statement activity and which requires significant manual periodic reconciliations to identify differences for research to ensure appropriate accounting in both processes.
- Although CMS utilizes the Healthcare Integrated General Ledger Accounting System (HIGLAS) in preparing its financial statements, the full functionality of HIGLAS has not

yet been implemented. CMS's durable medical equipment (DME) Medicare Administrative Contractors (MACs) have not fully implemented CMS's HIGLAS. For these contractors, the accuracy of the financial reports remains heavily dependent on inefficient, labor-intensive, manual processes that are also subject to an increased risk of inconsistent, incomplete, or inaccurate information being submitted to CMS and, ultimately, HHS for consolidation.

Resource limitations and other priorities have consistently been identified as the causes for delays in upgrading certain system and financial internal control processes limiting HHS's ability to comply with requirements under FFMIA.

With the ongoing implementation of the *Digital Accountability and Transparency Act* (the DATA Act) and the completed upgrades of its financial systems, HHS has made progress in addressing its compliance with FFMIA. As it continues its pursuit in resolving these long-standing issues, HHS should continue in developing, maintaining, and implementing consistent policies and procedures, monitoring the implementation of its upgrades, providing extensive training throughout the Department to ensure consistent application, and enhancing its monitoring program to ensure continued compliance.

### ***Financial Analysis and Oversight***

Because deficiencies continue to exist in the financial management systems, management must compensate for the deficiencies by implementing and strengthening additional controls to ensure that errors and irregularities are detected in a timely manner. Our review of internal control disclosed a series of deficiencies that may impact HHS's ability to report accurate financial information on a timely basis. Although certain improvements were noted, similar to prior years, we found that certain controls were not consistently performed to ensure that differences were properly identified, researched, and resolved in a timely manner and that account balances were complete and accurate. We identified the following items in the current year's audit that indicate additional improvements in the financial reporting systems and processes are required:

### ***Operating Division Periodic Analysis and Reconciliation***

As deficiencies exist in financial systems, management compensates by implementing and strengthening other manual controls to ensure that errors and irregularities are prevented or detected in a timely manner. These manual and compensating controls may include monitoring of budgets, reconciliations of accounts, analyses of fluctuations, aging of accounts, and manual and supervisory reviews. During our audit, we found that certain controls still required further improvements. The following represent specific areas that need enhanced periodic reconciliation and analysis:

- *Manual Journal Entries* – During FY 2016, although significant progress was made in certain OpDivs with the automation of certain transactions, more than 15,000 manual journal entries totaling approximately \$1.1 trillion in absolute value were recorded in the Unified Financial Management System (UFMS) and NBS to post certain types of routine and non-routine transactions – including transactions to record proprietary and budgetary entries, record accruals, perform adjustments between governmental and nongovernmental accounts, perform adjustments to agree budgetary to proprietary accounts, perform other reconciliation adjustments at period-end, and correct errors identified as related to configuration issues within UFMS and NBS. These entries are posted to UFMS and NBS to record both the proprietary and budgetary effects of financial activities for which the financial system may not be configured properly to post automatically. Although these entries are required to be posted to the general ledger in order for the financial statements to be accurate, many of these entries should be configured as routine systematic entries within the systems. HHS’s management indicated that it continues to develop and implement corrective actions to reduce the number of manual journal entries in future years.
- *Commissioned Corps* – During January 2014, HHS transferred the Commissioned Corps retiree payroll processes from a commercial financial shared service center to the U.S. Coast Guard. During FY 2015 and FY 2016, we determined that reviews of the respective Coast Guard internal control systems had not sufficiently taken place during the respective fiscal years nor had sufficient communications taken place to ensure timely access of Commissioned Corps data or documentation for audit purposes. HHS management has indicated that steps are being taken to ensure effective internal controls and appropriate access are available over its Commissioned Corps data.
- *Civilian Payroll Process* – HHS processes its civilian payroll through a series of computer systems and internal controls. During our FY 2016 audit, we noted certain internal control lapses, including the following: an incorrect pay calculation due to out-of-date personnel data entered on a new hire; information discrepancies between the two payroll systems which, resulted in inconsistencies in employee elections and deductions; and improper system updates, which resulted in untimely payroll reconciliations and untimely provisions of required personnel supporting documentation. We also observed deficiencies related to IT security, specifically relating to access and segregation of duties within certain payroll-related systems. HHS has indicated that it is working to resolve these control issues by strengthening IT security and manual controls.
- *Grant Accrual Process* – For more than 15 years, HHS’s Payment Management Service has utilized a linear regression analysis of its grant advance and disbursement amounts to derive a quarterly grant accrual for each of its OpDivs. In the first quarter of FY 2016, the process was automated to allow for a more timely and less labor-intensive calculation to be produced. During our interim audit procedures, we were able to recalculate the grant

accrual based on the linear methodology without exception. During our procedures at year-end, we noted differences totaling approximately \$1 billion between our calculation using the linear regression analyses and the HHS-calculated accrual for 9 out of 10 OpDivs. The Payment Management Service indicated that they modified the fourth quarter accrual using the linear regression analysis based on calculating a growth estimate and net adjustment for new programs, followed up with look-back methodologies to confirm reasonableness of the modified accruals. As part of our audit procedures to substantiate the modified amounts, we were unable to obtain formalized policies documenting the new approach or monthly/periodic analysis to substantiate the adjustments.

### ***Financial Management Controls at CMS***

We performed a separate audit of the financial statements of CMS and reported on the results of our audit, including a report on its internal controls dated November 4, 2016. In that report, we outlined details of deficiencies noted and made recommendations for improvement in its financial management controls. Consistent with our findings in the previous year, we concluded that the aggregation of these deficiencies and those related to business partner risk management, noted elsewhere in this report, to be a significant deficiency for the CMS internal control over financial reporting.

Our observations related to financial management controls included a recommendation that as CMS continues to enhance its data analyses capability, further improvement can be made by developing robust analytical procedures or measures against benchmarks to monitor and mitigate risks associated with the decentralized nature of CMS operations. To the extent more robust analysis occurs within Centers and Offices, identifying, evaluating, and reviewing such analysis would assist in ensuring that a perspective that incorporates a financial reporting point of view is captured and considered. It may be beneficial for CMS to identify a cross-functional working group to perform such analysis.

### ***Business Partner Risk Management at CMS***

CMS relies heavily on third-party contractors as it outsources substantially all the day-to-day operations for its information technology systems, the payment of Medicare fee-for-service and Medicaid claims and certain services related to the Medicare Part C and Part D programs. We identified areas where improvements could be made in the control environment related to the oversight of third-party contractors.

The contracts between CMS and its Medicare fee-for-service contractors include provisions that require the MACs to develop policies and procedures that satisfy the objectives established by CMS. Through the established procedures, CMS monitors the MACs' compliance with its policies and procedures, established internal controls, and the completeness and accuracy of financial reporting. While this approach to financial integrity supports CMS's role in the monitoring of the

MACs' financial controls, the oversight/monitoring process historically has not been fully effective in identifying and resolving financial recording and reporting issues or ensuring that the issues are remediated in a timely manner by the MACs.

As noted in the prior year, we identified deficiencies where actions are required but have not been taken or resolved in the following circumstances: (1) the Medicare Summary Notices, which are returned to the MACs but are not investigated as to why they are returned; (2) the claims outstanding greater than one year – periodically review, track, or monitor those aged claims other than those identified as bankruptcy, fraud, or abuse; and (3) the provider records – reconcile, review, or monitor provider records and provider eligibility status on a periodic basis to verify that all changes were processed in a timely, accurate, and complete.

## **Recommendations**

We recommend that HHS continue to develop and refine its financial management systems and processes to improve its accounting, analysis, and oversight of financial management activity. Specifically, we recommend that HHS perform the following:

- Continue to move forward to prioritize and centralize additional resources in addressing issues related to controls within and surrounding its financial information management systems.
- When all of the Federal Financial Reports (FFRs) for the quarter ended September 30, 2016 have been received, perform a look back analysis to the year-end grant accrual estimate. Using that analysis re-assess the grant accrual regression analysis and the need for the manual adjustments to that model made for the 2016 year-end close. Necessary revisions, if any, to the accrual process should be standardized to assure consistency of the process for each close. HHS should fully document any changes required to the model and processes. The adjusted policies should include providing monthly and/or quarterly documented analysis for each OpDiv to support the changes made to the automated linear regression analysis in determining the final grant accrual estimates so that OpDiv grants managers and financial management offices can complete their analysis and challenge of the fair presentation of the OpDiv financial statements.
- Continue to focus on automating and reducing the number of manual journal entries by determining the cause and the ability to upgrade systems to allow for automated posting of high-volume routine transactions and to ensure financial data is accurate. Additionally, we believe that HHS should strengthen controls surrounding review and approval functions around manual journal entries and reconciliations to provide for timely identification of errors and remediation of differences.

- Continue to focus on enhancing systematic and manual internal controls surrounding civilian payroll and Commissioned Corps data.

Additionally, we recommend that CMS continue to develop and refine its financial management controls and business partner risk management as a means to improve its accounting, analysis, and oversight of financial management activity. More detailed recommendations related to our specific findings on these topics are included in our CMS Report on Internal Control.

### ***NIH Financial Management Systems and Review Processes***

Although NIH upgraded its core financial system (NBS), performed additional analysis of its balances, and invested both HHS and NIH resources in overcoming certain deficiencies in its internal controls supporting information technology (IT) infrastructure and financial application systems in FY 2015 and FY 2016, NIH and our audit continue to identify deficiencies that require additional focus in FY 2017 and beyond. For example:

- *Financial Reporting Processes* – Beginning in FY 2014, Treasury required that agencies utilize its governmentwide Treasury Account Symbol Adjusted Trial Balance System (GTAS) to submit not only its required budgetary reporting, but its financial activities for purposes of developing the governmentwide financial statements. Treasury guidance also indicated that the balances reported in the agencies financial statements should be consistent with that included within GTAS. For GTAS, NIH produces bulk files using a web-based SQL server tool, which pulls data from NBS and allows for adjustments related to timing and reclassification differences to be made within the tool prior to GTAS submission. Whereas, financial statement activity is reported directly from NBS to Consolidated Financial Reporting System (CFRS). These two separate processes of reporting budgetary and financial statement activity require significant periodic reconciliations and may create significant differences between GTAS and CFRS. Due to timing differences, certain transactions are not reported consistently between processes, resulting in differences that require research and manual posting of entries to ensure both systems are synchronized after the end of the period. NIH management has indicated that it plans to better align its budgetary and financial reporting processes in order to ensure consistency and appropriate accounting.

Additionally, we noted that NBS does not electronically enforce some controls and sound accounting practices included in the HHS Accounting Treatment Manual. For example, we noted that NBS does not automatically close certain accounts and allows users to reopen previously closed periods. As a result additional analysis and manual adjustments are required to ensure the system will open in the next period with the proper beginning balances.

- *Manual Journal Entries* – As discussed above, HHS posts a significant number of manual journal entries, with the majority of the entries being generated by NIH. During FY 2016, although NIH’s annual total budgetary resources was only \$38 billion, NIH was required to process approximately 13,000 manual journal entries totaling an absolute value of more than \$897 billion to its NBS. These entries consist of nonstandard postings to record both the proprietary and budgetary effects of certain financial activities for which either the financial system is not configured properly to post automatically or to correct differences identified within the critical reconciliation processes of NBS to its subsidiary systems or GTAS balances to CFRS. Although necessary to ensure balances are accurate, the number of manual journal entries is significant compared to the NIH’s overall activity.

Additionally, we observed certain weaknesses in the manual journal entry process, including:

- Improper or lack of approvals to both routine and non-routine manual journal entries
- Allowing for the posting of certain entries that were inappropriate and required reversal
- Limited descriptions as to the purpose of the manual journal entry
- Insufficient controls and processes to determine what entries are routine and if all required entries were recorded in the proper period and for each period
- Insufficient documentation to support the purpose of certain non-routine entries

Our analysis of those entries did not cause us to change our opinion on the FY 2016 financial statements of HHS taken as a whole. However, we identified instances in which the research of the differences was inadequate, the supporting documentation underlying the manual journal entries was insufficient, and the HHS manual journal entries approval process was not followed. NIH management indicated that the reason for the large number of manual journal entries is due to system and resource limitations, the need to develop NIH-specific policies, and enhanced training of its personnel.

- *NIH’s Grant Accrual* – Quarterly, NIH recorded an estimated grant accrual to its financial data to ensure that reported financial statement balances were correct. Although the grant accrual supports all 27 institutes for each of the current six years of appropriations, NIH records its estimate to only one institute’s appropriation. At September 30, 2016, the estimated grant accrual totaled \$5.3 billion. NIH management indicated that at quarter-end, there was insufficient time to post an estimate to each of its approximately 200 appropriations. Additionally, the process is recorded through a manually intensive entry process that would increase the chance for mistakes during the posting in the current month and the reversal during the future period.

- *Policies and Procedures* – Although HHS has created a tracking system to develop and implement new policies, NIH has not taken the next step in developing NIH-specific desk procedures for its period-end closing to ensure all entries are recorded appropriately and complete.
- *IT System Infrastructure* – During our FY 2016 audit, we continue to identify deficiencies related to IT security, specifically relating to access and segregation of duties within NBS. NIH has indicated that it is working to resolve certain control issues by strengthening IT security and manual controls.

## **Recommendations**

We recommend that NIH:

- Analyze its routine manual journal entries to determine if certain entries should be configured within the NBS to limit the number of higher-risk entries.
- Enhance its internal control processes related to manual journal entries, including the development of NIH-specific procedures and training to ensure its policy is consistently applied. The policies should suggest developing a log of routine entries to ensure all postings are complete and appropriate. Additionally, we recommend the level of authorization be documented, especially for non-routine high-risk entries, and that minimum documentation supporting the entry be maintained.
- Continue to focus efforts in remediating internal control issues related to IT infrastructure and systems controls for its NBS.
- Develop a process to reasonably allocate NIH's grant accruals to each of its 27 institutes to allow for accurate GTAS reporting.
- Evaluate NIH's budgetary and financial reporting processes to better enable for consistent reporting and more timely determination of differences between the two processes.
- Develop monthly analyses prepared for the audit which should be formalized and made a part of the accounting records of NIH. In addition, the analysis and adjustment processes related to balances at NIH should be revised to assure differences are thoroughly researched and adjustments are properly documented and approved.

### *Status of Prior Year Findings*

In the reports on the results of the FY 2015 audit of the HHS financial statements, a number of issues were raised relating to internal control over financial reporting. The chart below summarizes the current status of the prior year items:

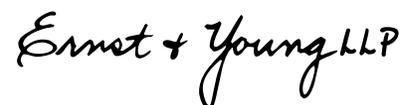
<b>Material Weakness</b>		
<b>Issue Area</b>	<b>Summary Control Issue</b>	<b>FY 2016 Status</b>
Financial Management Information Systems	<ul style="list-style-type: none"> <li>• Segregation of Duties</li> <li>• Configuration Management</li> <li>• Access Controls</li> <li>• FISMA Compliance</li> </ul>	Certain progress noted; certain issues need continued focus Modified Repeat Condition
<b>Significant Deficiencies</b>		
Financial Reporting Systems, Analyses, and Oversight	<ul style="list-style-type: none"> <li>• Lack of Integrated Financial Management System</li> <li>• Financial Analysis and Oversight</li> </ul>	Progress noted; however, certain issues identified require continued focus; Modified Repeat Condition
NIH Financial Management Close and Review Processes	<ul style="list-style-type: none"> <li>• Documentation to support NIH review and approval process is insufficient.</li> </ul>	Progress noted; however, certain issues identified require continued focus; Modified Repeat Condition

### **HHS's Response to Findings**

HHS's response to the findings identified in our audit and examination are included in the accompanying letter dated November 14, 2016. HHS's response was not subjected to either the auditing procedures applied in the audit of the financial statements or the attest procedures applied in the examination of internal control, and, accordingly, we express no opinion on it.

### **Purpose of This Report**

The purpose of this report is solely to describe the scope of our testing of internal control and the results of that testing, and not to provide an opinion on the entity's internal control. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control. Accordingly, this communication is not suitable for any other purpose.



November 14, 2016



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## Report of Independent Auditors on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance With *Government Auditing Standards*

The Secretary and the Inspector General of the  
U.S. Department of Health and Human Services

We have audited, in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States and the Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*, the consolidated financial statements of the Department of Health and Human Services (HHS or the Department), which comprise the consolidated balance sheet as of September 30, 2016, and the related consolidated statement of net cost and changes in net position and the combined statement of budgetary resources for the fiscal year then ended, and the related notes to the principal financial statements, and we were engaged to audit the statement of social insurance as of January 1, 2016, and the related statement of changes in social insurance amounts for the period ended January 1, 2016, and have issued our report thereon dated November 14, 2016. That report states that because of the matters described in the Basis for Disclaimer of Opinion paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the statement of social insurance as of January 1, 2016, and the related statement of changes in social insurance amounts for the period ended January 1, 2016.

### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether HHS's consolidated financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 15-02, including the requirements referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA) (P.L.104-208). However, providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit, and, accordingly, we do not express such an opinion. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to HHS.

The results of our tests of compliance with the laws and regulations described in the second paragraph of this report disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 15-02, as described below.

During fiscal year (FY) 2016, HHS's management determined that it may have potential violations of the Anti-Deficiency Act (P.L. 101-508 and OMB Circular A-11) related to FY 2015 and FY 2016 obligation of funds for conference spending. Additionally, HHS's management determined that its Medicare appeals process did not adjudicate appeals within the statutory decisional time frames required by the *Social Security Act*.

The *Improper Payments Information Act of 2002* (IPIA) (P.L. 107-300) as amended by the *Improper Payments Elimination and Recovery Act of 2010* (IPERA) (P.L. 111-204) and the *Improper Payments Elimination and Recovery Improvement Act of 2012* (P.L. 112-248) (hereinafter, the "Acts") require federal agencies to identify the program and activities that may be susceptible to significant improper payments and estimate the amount of the improper payments. While the Department continues to make progress, HHS currently is not in full compliance with the requirements of the Acts. For example, HHS has reported improper payment error rates for each of its high-risk programs, or components of such programs, except for the Temporary Assistance for Needy Families (TANF). HHS indicated that it is unable to compel states to collect the necessary information required to conduct an improper payment measurement for TANF due to Section 411 of the *Social Security Act*, which specifies the data elements that HHS may require states to report, and Section 417 of the same *Social Security Act*, which dictates that the federal government may only regulate the conduct of states where Congress has given them the express authority. Accordingly, HHS feels that it does not have the authority to collect data pertaining to case and payment accuracy for TANF since the information is not included under the *Social Security Act*. Additionally, we noted certain high-risk programs that did not meet their identified targets or exceeded the maximum 10% threshold stipulated by OMB. Also, HHS is not in full compliance with Section 6411 of the *Patient Protection and Affordable Care Act*, as HHS has not yet implemented recovery activities of the identified improper payments for the Medicare Advantage (Part C) program. HHS indicated it remains committed to implementing this provision of the *Affordable Care Act*, and anticipates awarding a Medicare Part C Recovery Audit Contractor contract in 2017.

Under FFMIA, we are required to report whether HHS's financial management systems substantially comply with federal financial management systems requirements, applicable federal accounting standards, and the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements. The results of our tests disclosed instances in which HHS's financial management systems did not substantially comply with certain requirements as discussed above. We have identified the following instances of noncompliance related to FFMIA:

- During FY 2016, HHS recorded approximately \$1.1 trillion in manual journal entries, as these transactions are not currently configured correctly within the financial systems and are for the purpose of ensuring that balances within financial systems are correct to enable the development of periodic financial statements and other required reporting.
- The lack of sufficient integration within certain financial systems are not complemented with sufficient manual preventative and detective-type controls, including the NIH Business System, which continues to utilize two separate processes to report budgetary and financial statement activity and which requires significant periodic manual reconciliations to identify differences for research to ensure appropriate accounting in both processes.
- Although the Centers for Medicare & Medicaid Services (CMS) utilizes the Healthcare Integrated General ledger Accounting System (HIGLAS) in preparing its financial statements, the full functionality of HIGLAS has not yet been implemented. CMS's durable medical equipment (DME) Medicare Administrative Contractors (MACs) have not fully implemented CMS's HIGLAS. For these contractors, the accuracy of the financial reports remains heavily dependent on inefficient, labor-intensive, manual processes that are also subject to an increased risk of inconsistent, incomplete, or inaccurate information being submitted to CMS and, ultimately, HHS for consolidation.
- Although progress was noted, reviews of general and application controls over financial management systems identified certain departures from requirements specified in OMB A-130, *Management of Federal Information Resources*, and OMB A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*. Additionally, the Office of Inspector General (OIG) identified certain issues, including access control deficiencies related to systems as part of its Federal Information Security Management Act and other OIG engagements. Finally, HHS management has identified certain weaknesses within its information technology general and application controls during its assessment of corrective action status and its OMB A-123 processes.

\* \* \* \* \*

## **HHS's Response to Findings**

Our Report on Internal Control dated November 14, 2016, includes additional information related to the financial management systems that were found not to comply with the requirements, relevant facts pertaining to the noncompliance to FFMIA, and our recommendations related to the specific issues presented. It is our understanding that management agrees with the facts as presented and that relevant comments from HHS's management responsible for addressing the noncompliance are provided in its letter dated November 14, 2016. HHS's response was not subjected to either the auditing procedures applied in the audit of the financial statements or the attest procedures applied in the examination of internal control, and, accordingly, we express no opinion on it.



Additionally, HHS is updating its Department-wide corrective action plan to address FFMIA and other financial management issues.

### **Purpose of This Report**

The purpose of this report is solely to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on HHS's compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering HHS's compliance. Accordingly, this communication is not suitable for any other purpose.

*Ernst + Young LLP*

November 14, 2016