Management Information Report
Evaluation of the Control Environment at the Railroad Retirement Board
Report No. 02-08, August 1, 2002

INTRODUCTION

This management information report presents the results of the Office of Inspector General's (OIG) evaluation of the control environment at the Railroad Retirement Board (RRB).

BACKGROUND

The RRB is an independent agency in the executive branch of the Federal government. The RRB administers the health and welfare provisions of the Railroad Retirement Act (RRA) which provide retirement-survivor benefits for eligible railroad employees, their spouses, widows and other survivors. During fiscal year (FY) 2001, approximately 700,000 annuitants received benefits totaling $8.5 billion under the RRA.

The RRB also administers the Railroad Unemployment Insurance Act (RUIA) which provides unemployment and sickness insurance to workers in the rail industry. During FY 2001, the RRB paid $94.4 million to the 18,000 individuals qualifying for unemployment benefits and the 24,000 individuals qualifying for sickness benefits under the RUIA.

The RRB is administered by a three-member Board appointed by the President, by and with the advice and consent of the Senate. Each member holds a term of office for five years. Under the provisions of the RRA, one member is appointed upon recommendations made by representatives of railroad employees and one member is appointed from recommendations made by representatives of railroad employers. The third member, designated to chair the agency, is appointed without the recommendation of either employers or employees and cannot have an interest, financial or otherwise, in any railroad employer or organization of railroad employees.

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- effectiveness and efficiency of operations,
- reliability of financial reporting, and
- compliance with applicable laws and regulations.

In Standards for Internal Control in the Federal Government, the General Accounting Office (GAO) has established five standards for internal control:

- control environment,
- risk assessment,
- control activities,
- information and communications, and
- monitoring.

A positive control environment is the foundation for all other standards, providing discipline and structure as well as the climate that influences the quality of internal control. The GAO has identified seven factors that affect the control environment of a Federal agency:

- integrity and ethical values,
- commitment to competence,
- management's philosophy and operating style,
- organizational structure,
- assignment of authority and responsibility,
- human capital policies and practices, and
- the agency's relationship with Congress and central oversight agencies such as the Office of Management and Budget.

Financial statement audits conducted by the OIG and predecessor auditors, Arthur Andersen LLP and KPMG Peat Marwick, have cited the RRB's overall control environment as a material weakness every year since FY 1993. However, the three-member Board believes that past reorganizations have eliminated the material weakness. As a result, the RRB did not include the OIG's findings concerning the overall control environment as a material weakness in the statements of assurance that were issued pursuant to the Federal Managers' Financial Integrity Act, for FYs 1997 through 2001.

Reportable conditions are matters relating to significant deficiencies in the design or operation of internal control that could adversely affect the agency's ability to record, process, summarize, and report financial data. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

OBJECTIVE, SCOPE AND METHODOLOGY

The objective of this evaluation was to assess effectiveness of management in establishing and maintaining a positive control environment during FY 2001 and FY 2002.

In order to achieve this objective, we assessed the applicability and impact of the seven factors critical to the control environment. In making our assessment we considered the findings of prior financial statement audits.

Fieldwork was conducted at RRB headquarters during October 2001 through February 2002.

EVALUATION RESULTS

The RRB's control environment is not fully effective in creating a positive and supportive attitude toward internal control. During our evaluation, we identified inadequacies related to three of the seven control environment factors described by the GAO in their Standards for Internal Control in the Federal Government:

- the communication of management's philosophy;
- the ability of the agency's organizational structure to provide an adequate framework for planning, directing, and controlling operations to achieve agency objectives; and
- the manner in which authority and responsibility are delegated throughout the organization.

We attribute these weaknesses to the manner in which the legislatively mandated three-member Board has been implemented at the RRB. The three-member Board governing body, as it has historically been implemented at this agency, precludes identification of a cohesive management philosophy, focuses attention away from the objectives of the organization as a whole and fragments responsibility.

Our criticism of the implementation of the three-member Board is not targeted at the performance of any individual Board member, present or past. It is the OIG's view that the organizational form itself, regardless of any individual appointee, is ill-designed for day-to-day management responsibilities. A multi-member governing body, such as the RRB's three-member Board is most effective when it restricts its involvement in organizational operations to high level policy-setting.

As a result, the RRB's overall control environment is not adequate to ensure that agency financial statements will be free of material misstatements and prepared in accordance with applicable guidance.

Recommendation

We recommend that the three-member Board limit its participation in agency affairs to high-level policy-setting and vest responsibility for implementation to a newly created position of Chief Executive Officer.

Management's Response

The three-member Board disagrees with the finding and recommendation. The full text of their response is presented as an appendix to this report.

Management's Philosophy

Management's philosophy and operating style determine the degree of risk the organization is willing to take and management's philosophy towards performance-based management. The attitude and philosophy of management toward information, systems, accounting, personnel functions, monitoring and audits and evaluations can have a profound effect on internal control.

By legislative design, each Board member represents a different constituency, their points of view are sometimes divergent. They do not speak with a single voice. Rather, each member of the Board tends to function as a chief executive, with differing management philosophies and operating styles. As a result, it is difficult for lower levels of agency management to apply "management's philosophy" because it is difficult to discern, frequently undocumented, and in some cases, nonexistent.

At the RRB, management's philosophy and operating style emanates from management levels below the three-member Board. Each organization is influenced by the views of the Board member that takes particular interest in their operations. For example, the Labor Member has a natural interest in benefit payment operations that is consistent with his position as a representative of rail labor. The Management Member often takes an active interest in matters related to financial accountability.

The creation of a three-member Board to head the agency has been effective in creating a balance between the interests of labor and management in the railroad retirement program. However, the manner in which it has been implemented permits the members' divergent views to impact management at lower levels, leaving the agency, regardless of political administration, without a recognizable philosophy or operating style.

Organizational Structure

An entity's organizational structure provides management's framework for planning, directing, and controlling operations to achieve agency objectives.

Arthur Andersen LLP first identified a material weakness in the RRB's overall control environment during their audit of the agency's FY 1993 financial statements. The auditors noted that the agency's internal control environment was focused on control objectives and techniques designed to meet the organizational responsibilities of individual organizational units rather than those of the agency. At that time, the RRB's management structure was composed of 20 bureaus plus the three Board members and their staffs.

During the succeeding years, we have observed reductions in the number of agency operating units as well as the creation of an Executive Committee. The present administrative organization consists of 16 operational units grouped into six major organizations whose directors report to the three-member Board.

The RRB's organizational structure is inherently flawed because it lacks a single chief executive officer. The lack of a single chief executive officer leaves accountability and strategic leadership vested at too low a level of agency management to ensure timely, effective action on matters that could impact the financial reporting.

The present organizational structure impedes the resolution of problems because it does not offer the kind of top-down leadership that fosters cross-organizational teamwork. Management at the operational level cannot look directly to the three-member Board for leadership.

As in the past, the three-member Board continues to have significant involvement in the day-to-day operational affairs of the agency. For example, the three-member Board must approve the travel plans and vouchers of key executives; approve requisitions over $100,000; personnel appointments above the GS-13 level; and personnel appointments at any level when four or more similar positions are being filled.

However, the Board itself is not readily approachable as an entity. Assistants to the various Board members play an intermediary role. Each Board member fields assistants to represent them in discussions with lower levels of management, adding a layer of bureaucracy to an already highly structured management environment.

Delegation of Authority and Responsibility

The control environment is also affected by the manner in which authority and responsibility are delegated throughout the organization.

Within the RRB, authority and responsibility flow from the three-member Board to the heads of the six major organizational units. There is no Chief Executive Officer.

In 1999, the three-member Board approved creation of an Executive Committee. Under the direction of a Senior Executive Officer, the Executive Committee was designated to:

- oversee the day-to day operations of the agency;
- makes recommendations to the three-member Board on agency-related policy and issues; and
- promote coordination and communication on matters of agency-wide policy and direction.

The Executive Committee is also responsible for oversight and problem-solving regarding cross-organizational internal control issues.

Although the Executive Committee created a new forum for cross-organizational coordination, it did not represent a departure from the RRB's historic organizational or power structure. The Executive Committee is composed of the six top agency executives who, prior to the creation of that committee, directed the agency's day-to-day operations through their respective positions in the established hierarchy. Each member of the committee reports directly to the three-member Board. The agency's fundamental internal relationships remain unchanged.

The three-member Board's reluctance to centralize authority below Board-level has resulted in a kind of administrative inertia which impedes, rather than facilitates, problem resolution.

Effect on Internal Control, Financial Reporting and Compliance

The OIG has observed the adverse effect of a weak control environment on the ability of the agency to respond to new challenges. A discussion of some notable examples is presented below.

Internal Control

During FY 2001, we conducted an extensive review of information security. During that review process we noted that the security program lacked a strong security framework with a central management focal point. The absence of such a framework and focal point was cited as the underlying cause for many of the control weaknesses identified by the audit.

Our observation that security responsibilities were distributed throughout the agency without guidance or oversight from a strong central authority is consistent with an apparent reluctance to concentrate cross-organizational authority below the Board level.

Financial Reporting

Accountability for problems rests with the organizational unit that has apparent responsibility for that functional area of agency operations. The resources of the larger organization are not brought to bear on problems. As a result, the agency has experienced difficulties in resolving financial accounting and reporting issues that would have benefited from a cross-organization problem-solving initiative.

During the OIG's audit of the RRB's financial statements for the fiscal year ended September 30, 2001, we experienced, not for the first time, difficulty in obtaining the required management representation letter from the three-member Board. This unnecessary complication sends lower levels of agency management and staff a message that indicates a lack of support for the financial reporting process.

The public accountants, and later the OIG, raised concerns about the impact of benefit payment errors on the financial statements and the accuracy of accounting estimates used to record and report the RRB's financial interchange with the Social Security Administration. In both of the above situations, the responsibility for resolving the auditor concerns remained with the organizational unit most visibly responsible for the related operational area.

However, both matters would have benefited from the attention of other professional specialties. In neither case, did the three-member Board provide the leadership that would have facilitated the problem resolution process. As a result, the agency was repeatedly cited for non-compliance with the RRA as well as material internal control weaknesses that were reported in conjunction with disclaimers of opinion on the annual financial statements.

<u>Compliance</u>

The 1981 and 1983 amendments to the Social Security Act reduced or denied benefits in some cases in which benefits had previously been paid under that Act. Although the RRA was not similarly amended, the RRB applied the Social Security Act amendments to the tier I portion of benefits paid under the RRA. An RRA annuity may be composed of up to four parts; tier I is computed using Social Security formulae.

Based on the 1981 amendments to the Social Security Act, the RRB denied tier I benefits to persons who would have otherwise qualified for benefits based on the children aged 16 to 18 in their care. Benefits had previously been payable until a child reached age 18. Similarly, the 1983 amendments led the RRB to deny tier I benefits to incarcerated felons.

The RRB did not seek conforming legislation until 1991, when it lost a second court challenge by a mother who had been denied benefits because she no longer had a child under age 16 in her care. The agency did not change its policy toward adjudicating such cases until 1992 when it lost in a third case.[1]

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[1] The three cases were:

- <u>Costello</u> v. <u>Railroad Retirement Board,</u> Eighth Circuit, 1985;
- <u>Claudette Johnson</u> v. <u>Railroad Retirement Board,</u> Eleventh Circuit, 1991; and

The RRB continued to withhold the tier I benefits of incarcerated felons pursuant to the 1983 amendments to the Social Security Act until 1995 when the agency was threatened with legal action by a knowledgeable appellant who cited the Nancy Johnson case.

The slow progress of this issue, 14 years, raises questions about the agency's ability to identify and resolve matters that could represent a source of future financial liability.

Material Weakness

The RRB's control environment is not fully effective in creating a positive and supportive attitude toward internal control. As discussed in the preceding sections of this report, we believe that this weakness is due to the level of involvement that the agency's three-member Board has traditionally had on day-to-day operations.

As in the past, we have concluded that the overall control environment is a source of material weakness in internal control. Experience has shown that the control environment does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

- Nancy Johnson v. Railroad Retirement Board, District of Columbia Circuit, 1992.

REINVENTING THE RAILROAD RETIREMENT BOARD

The RRB operates in a dynamic environment that puts stress on its internal control framework. The agency's customer base is falling rapidly while the cost of doing business is rising. During the last decade of the 20th century:

- railroad employment dropped by approximately 14%;
- the number of annuitants fell by 23%; and
- the agency's administrative costs increased by 15%.

In addition, the Railroad Retirement and Survivors Improvement Act of 2001 altered the structure of the benefits and financing under the RRA. This legislation also included innovative provisions providing for the investment of RRA trust fund monies in non-government securities and the transfer of benefit payment operations to a private, non-Federal disbursement agent.

In 1995, the RRB's Inspector General published the first in a series of proposals challenging the three-member Board to re-examine the agency's organizational structure and the way in which it does business.

The six reinvention proposals published since 1995 included recommendations for:

- the redesign of the agency's organizational structure;
- reduction of the size and scope of the agency field service;
- transfer of adjudicative and administrative responsibilities for Social Security Equivalent Benefits to the Social Security Administration; and
- replacement of the agency's historical form, a Federal agency headed by a three-member Board, with a government corporation.

However, the three-member Board has not been responsive to these proposals and the IG has observed only superficial changes in the agency's organizational structure and field service operations. The RRB continues to operate within a traditional bureaucratic framework.

As in the past, the OIG will continue to challenge the three-member Board to bring this agency into the 21st century.

UNITED STATES GOVERNMENT

MEMORANDUM

FORM G-115f (1-92)

RAILROAD RETIREMENT BOARD

JUL 30 2002

TO : Henrietta B. Shaw
Assistant Inspector General, Audit

FROM : The Board

SUBJECT : Management Information Report – Evaluation of the Control Environment at the Railroad Retirement Board

This is in response to your memorandum dated July 1, 2002, to the Chair of the Railroad Retirement Board seeking review and comments on a draft of the above referenced Management Information Report. We appreciate the opportunity to review and comment on the draft report.

The draft repeats recommendations made previously by the Office of Inspector General concerning the structure of the Railroad Retirement Board. Briefly stated, the recommendations are that the three-member Board limit its involvement to high-level policy matters and not involve itself in the day-to-day operations of the agency and that the Board centralize management of the agency in a single official immediately below the Board. The recommendations are designed to address perceived organizational weaknesses that your report suggests manifest themselves in performance problems, an inability to respond to new challenges, and in possible misstatements in the agency's financial statements. In our view, the actual circumstances do not support the conclusions that underlie your recommendations. On the contrary, available evidence suggests that the agency is well managed.

As you point out in your draft report, the Board has made changes in the organizational structure of the agency that we believe have addressed past recommendations by your office. The Board has established an Executive Committee, headed by the Senior Executive Officer, to which the Board has delegated responsibility and authority to manage the day-to-day operations of the agency. The Executive Committee, under the direction of the Senior Executive Officer, has made significant progress in refocusing the agency's resources on accomplishment of the agency's mission. The Executive Committee members operate as a team, not as a group of individuals, as you seem to suggest, in overseeing the day-to-day operations of the agency. The Board has delegated authority to the Senior Executive Officer to direct the Executive Committee. While the individual Executive Committee members report directly to the Board, the charter of the Executive Committee provides that the Board may seek input from the Senior Executive Officer in appraising the performance of Executive Committee members.

While the Board members continue to have some oversight responsibilities with respect to aspects of agency operations, such as approval of certain travel, approval of large expenditures, and approval/review of certain personnel actions, we view our limited involvement as constructive and not designed to curtail the authority of managers. Although we have authority in these areas, we have rarely exercised this authority to disapprove proposed travel, disapprove procurements, or to second-guess personnel decisions by agency management. We view this authority more as a means by which we can keep abreast of matters within the agency.

Moreover, we disagree with the suggestion in your report that the composition of the Board results in no single management direction for the agency. While we may not always agree on the best method of achieving the agency's mission, we agree completely that it is the agency's mission that is paramount and we will put aside individual differences in order to achieve the mission. We feel that healthy debate among the Board members results, in many cases, in a better, informed decision and in a decision that we can all stand behind and support.

We think there is no better way to judge the effectiveness of an organization and of an organization's structure than to look at the organization's actual performance and accomplishments. We feel that an objective review of the agency's performance and accomplishments over the past few years shows clearly that the agency is well run and that the organizational weaknesses suggested in your report do not exist.

The agency has adopted a Strategic Plan that is updated periodically to guide us in administration of the Railroad Retirement and Railroad Unemployment Insurance Acts. Based on this plan, we establish annual performance plans to judge the effectiveness of the agency in achieving the goals essential to achievement of the agency's mission. The goals are agency-wide goals and the performance of our Executive Committee members is measured uniformly on how the agency does in accomplishing these goals. Thus, for example, a problem in achieving a benefit payment objective is reflected not only in the performance appraisal of the Director of Programs, but may also be reflected in the appraisals of the other Executive Committee members.

Despite the fact that the agency has set high standards in its goals and objectives in the annual performance plans, the agency has, over the past several years, achieved or surpassed nearly all of the performance objectives. Benefit payments are accurate and timely, program integrity objectives have been met, and resources directed towards improvements in automation are beginning to pay dividends. Moreover, the agency achieved a very high satisfaction rating in a study conducted in 2001 by the American Customer Satisfaction Index, an independent group that studies customer satisfaction in both the public and private sectors. What is particularly noteworthy about the agency's performance over the past several years is that we have achieved very favorable results notwithstanding the fact the agency's FTE levels have declined dramatically over the last ten years. Between 1993 and 2002, the agency's FTE levels have declined from nearly 1700 to approximately 1100.

Your report suggests that the agency's organizational structure makes it difficult to respond to new challenges. An example that you cite in support of your finding, the results of a recent review of the agency's IT security program, serves, in our view, to show that the agency can quickly respond to challenges. The agency has centralized responsibility for IT security in the Chief Information Officer and the Board recently approved a reorganization of the Bureau of Information Security that created a new Risk Management Group, headed by the Chief Security Officer. The agency's response to other significant challenges also suggests that the agency is very capable of meeting new challenges. Despite dire predictions, the RRB effectively and efficiently met the challenge of updating its automated systems to operate after 1999. Our Y2K project was a complete success and the changeover to the new century was done without a problem. The other major, recent accomplishment was and continues to be implementation of the Railroad Retirement and Survivors' Improvement Act of 2001. This legislation changes several benefit provisions of the Railroad Retirement Act. Over 500 employees from the various offices and bureaus worked closely together to make the changes necessary to get increases in benefit payments into the hands of beneficiaries as quickly as possible and to provide information to beneficiaries concerning the changes in the benefit program. The handling of this very important initiative shows that the agency can and does work as a team.

Finally, your report suggests that the organizational structure of the RRB raises the possibility of misstatements in the agency's financial statements. There is also a suggestion that the amount of time it took the Board to approve the management representation letter suggests a lack of support for financial reporting among the Board members. We see no basis for these allegations. With respect to the accuracy of our financial statements, your office rendered a clean opinion on the agency's most recent financial statements. As to the suggestion that the Board members may not fully support the financial reporting process, it should be pointed out that the Railroad Retirement Board is not one of the agencies required by statute to have audited financial statements. We understand the importance of financial statements and fully support the financial reporting process.

As set forth above, we do not agree with the recommendations made in the draft Management Information Report on Evaluation of the Control Environment at the Railroad Retirement Board.

Cherryl T. Thomas

V. M. Speakman, Jr.

Jerome F. Kever