GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE INSPECTOR GENERAL

DISTRICT OF COLUMBIA

UNEMPLOYMENT COMPENSATION FUND

Financial Statements and
Management's Discussion and Analysis
(with Independent Auditors' Report Thereon)
Years Ended September 30, 2010, and 2009

CHARLES J. WILLOUGHBY
INSPECTOR GENERAL

OIG No. 11-1-12BH **April 1, 2011**

GOVERNMENT OF THE DISTRICT OF COLUMBIA
Office of the Inspector General

Inspector General

April 1, 2011

The Honorable Vincent C. Gray
Mayor
District of Columbia
Mayor's Correspondence Unit, Suite 316
1350 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

The Honorable Kwame R. Brown
Chairman
Council of the District of Columbia
John A. Wilson Building, Suite 504
1350 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

Dear Mayor Gray and Chairman Brown:

As part of our contract for the audit of the District of Columbia's general purpose financial statements for fiscal year (FY) 2010, KPMG LLP (KPMG) submitted the enclosed final report on the District of Columbia Unemployment Compensation Fund (Fund) Financial Statements for years ended September 30, 2010 and 2009 (OIG No. 11-1-12BH).

KPMG opined that the financial statements present fairly, in all material respects, the financial position and cash flows of the Fund, for the years ended September 30, 2010, and the changes in financial position for the year then ended in conformity with United States of America generally accepted accounting principles. In accordance with *Government Accounting Standards*, KPMG also issued its report on consideration of the Fund's internal control over financial reporting which identified two material weaknesses: 1) lack of effective controls over financial reporting; and 2) ineffective general information technology controls. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of an entity's financial statements will not be prevented, or detected and corrected on a timely basis. As indicated in KPMG's report, the D.C. Department of Employment Services generally concurred with the findings and recommendations, and has taken corrective action.

If you have questions or need additional information, please contact Ronald W. King, Assistant Inspector General for Audits, at (202) 727-2540.

Sincerely,

Charles J. Willoughby
Inspector General

Enclosures

CJW/ws

cc: See Distribution List

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GOVERNMENT OF THE DISTRICT OF COLUMBIA
UNEMPLOYMENT COMPENSATION FUND

Financial Statements

September 30, 2010 and 2009

(With Independent Auditors' Report Thereon)

GOVERNMENT OF THE DISTRICT OF COLUMBIA
UNEMPLOYMENT COMPENSATION FUND

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KPMG LLP
2001 M Street, NW
Washington, DC 20036-3389

Independent Auditors' Report

The Mayor and the Council of the Government of the District of Columbia
Inspector General of the Government of the District of Columbia:

We have audited the accompanying statement of net assets of the Government of the District of Columbia's Unemployment Compensation Fund (the Fund) as of September 30, 2010, and the related statements of revenues, expenses and changes in net assets and statement of cash flows for the year then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit. The accompanying financial statements of the Fund as of September 30, 2009 were audited by other auditors whose report thereon dated February 19, 2010 expressed an unqualified opinion on those financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows of the Fund. They do not purport to, and do not, present fairly the financial position of the Government of the District of Columbia, as of September 30, 2010, the changes in its financial position, or where applicable, its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position and cash flows of the Fund as of September 30, 2010, and the changes in financial position for the year then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 16, 2011 on our consideration of the Funds internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report 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. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

KPMG LLP is a Delaware limited liability partnership, the U.S. member firm of KPMG International Cooperative ("KPMG International"), a Swiss entity.

KPMG

The Management Discussion and Analysis on pages 3 through 7 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

February 16, 2011

GOVERNMENT OF THE DISTRICT OF COLUMBIA
UNEMPLOYMENT COMPENSATION FUND

Management's Discussion and Analysis

September 30, 2010

This section of the annual financial report of the District of Columbia Unemployment Compensation Fund (the Fund) presents the discussion and analysis of the financial performance of the Fund during the fiscal year ended September 30, 2010. This discussion has been prepared by management and should be read in conjunction with the financial statements and note disclosures. The financial statements, disclosures, and discussion and analysis are the responsibility of management.

Reporting Entity

The Fund was established by the Government of the District of Columbia (the District) to account for its unemployment compensation program. The Fund is administered by the District's Department of Employment Services. Substantially all administrative costs of the program are paid by a federal grant, which is recorded in the District's General Fund.

Financial Statement Presentation

The Fund's basic financial statements consist of (a) statement of net assets; (b) statement of revenue, expenses, and changes in net assets; and (c) statement of cash flows.

- *Statement of Net Assets*

  The statement of net assets represents the Fund's assets, liabilities, and net assets. Net assets are the difference between assets and liabilities. Over time, increases or decreases in the Fund's net assets may serve as an useful indicator of whether the Fund's financial position is improving or deteriorating.

- *Statement of Revenue, Expenses, and Changes in Net Assets*

  The statement of revenue, expenses, and changes in net assets represent information showing how the Fund's net assets have changed during the fiscal year. All changes in net assets are reported as soon as the event underlying the change occurs without respect to the timing of the related cash flows. Accordingly, the revenues and expenses reported in this statement for certain items will result in cash flow in future periods (e.g., accounts receivable and accrued liabilities).

- *Statement of Cash Flows*

  The statement of cash flows represents information on sources and uses of cash for operations, noncapital financing, and investing activities.

Financial Highlight

At September 30, 2010, the District's average unemployment rate was 10.9%, which was a 22.47% increase from 2009. This increase resulted in a decrease in the Fund's net assets by $71,478.

(Continued)

Overall Financial Analysis (in $000)

Summary of Net Assets

	2010	2009	Change ($)	2008
Assets:				
Cash held with U.S. Treasury	$ 322,826	366,403	(43,577)	422,799
Receivables	23,646	28,470	(4,824)	7,608
Total assets	$ 346,472	394,873	(48,401)	430,407
Liabilities:				
Payables	$ 79,531	70,329	9,202	44,987
Due to D.C. Government	33,645	19,770	13,875	11,138
Total liabilities	$ 113,176	90,099	23,077	56,125
Net assets:				
Restricted for unemployment compensation benefits	$ 233,296	304,774	(71,478)	374,282

- The Fund's largest asset is the cash held with U.S. Treasury, which represented 93.18% of the Fund's total assets. The cash balance decreased by $43,577, as a result of unemployment benefits payments exceeding the cash receipts from employer taxes and governmental agencies.
- Receivables, net of allowance for doubtful accounts, decreased by $4,824. The Fund's receivables consist of amounts owed from the federal government and other states for unemployment benefits paid, unpaid taxed from employers, and claimants for unemployment benefit overpayments. The federal government paid claimants an additional $25 dollars in weekly unemployment benefits under the American Recovery and Reinvestment Act of 2009 (stimulus funds). It also paid the extended benefits received by claimants. Claimants who have exhausted their regular unemployment benefits and have met certain requirements were eligible for additional weeks of unemployment compensation benefits.
- The Fund's liabilities increased by $23,077 or 25.61%. Amounts due to claimants for unemployment benefits comprise a major portion of the payables. This claimant payable that has been estimated at $66,952 increased from prior year as a result of the continued high rate of unemployment in the District. In 2009, the claimant payable was $61,028. The Fund's payables to D.C. Government increased by $13,875, a 70.18% jump from 2009 due to higher unemployment in the District.
- Due to D.C. Government represents amounts owed to the District for unemployment benefits and employer tax refunds paid on behalf of the Fund and the Reed Act funds received from the federal government to be used by the District to pay for the Fund's administrative costs. In 2010, the Fund received an additional $18,422 in Reed funds from the federal government. During the 2010 fiscal year, the Fund remitted $1,148 of the available Reed funds to the District for a portion of the administrative costs incurred for the fiscal year. At September 30, 2010, the unspent Reed Funds totaled $35,781.
- The Fund's current assets of $346,472 were sufficient to cover current liabilities of $113,176, a ratio of $3.06 dollars in assets for every dollar in liabilities.

(Continued)

Summary of Revenues, Expenses, and Changes in Net Assets (in $000)

	2010	2009	Change ($)	2008
Revenues:				
Employer taxes	$ 129,470	94,622	34,848	95,298
Governmental contributions	36,998	36,985	13	18,627
Total revenue	166,468	131,607	34,861	113,925
Expenses:				
Unemployment benefits	480,976	370,775	110,201	150,237
Operating loss	(314,508)	(239,168)	(75,340)	(36,312)
Nonoperating revenues:				
Interest revenue	13,532	18,417	(4,885)	19,918
Federal contributions	229,498	151,243	78,255	15,529
Total nonoperating revenues	243,030	169,660	73,370	35,447
Change in net assets	(71,478)	(69,508)	(1,970)	(865)
Total net assets – beginning	304,774	374,282	(69,508)	375,147
Total net assets – ending	$ 233,296	304,774	(71,478)	374,282

Revenues

In fiscal year 2010, the Fund's operating revenue totaled $166,468 compared to $131,607 in fiscal year 2009. Operating revenues increased by 26.49% due to increases in governmental contributions, which increased as more former employees filed for unemployment benefits. Federal and other governments reimburse the Fund 100% for benefits paid to their former employees. Operating revenue came primarily from employer taxes.

Revenues from all sources (operating and nonoperating) totaled $409,498 in 2010 compared to $301,267 in 2009. The sources of operating revenue for the Fund in fiscal year 2010 include:

- $129,470 from employer taxes,
- $8,797 from other states' contributions,
- $9,233 from the federal government (contribution), and
- $18,968 reimbursed from the District government.

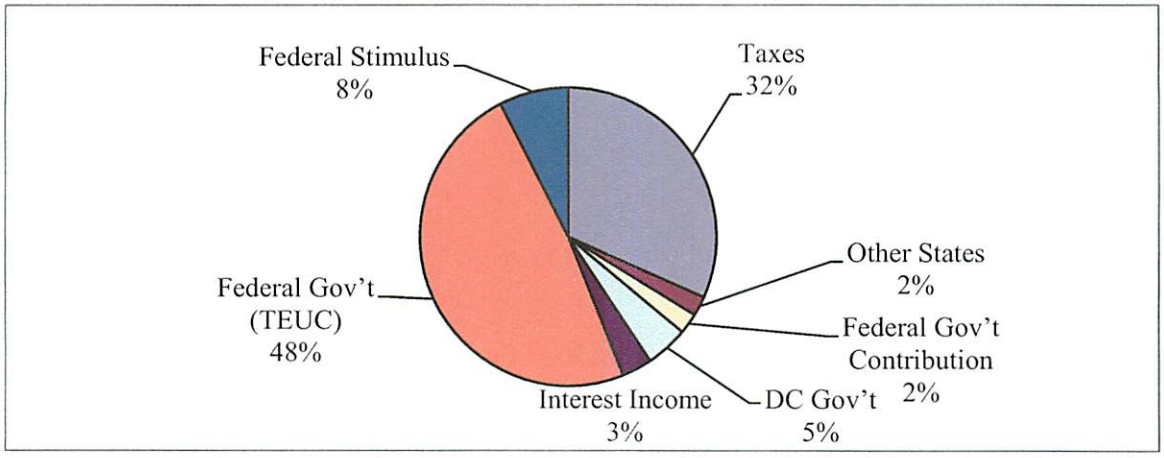
The Fund's sources of nonoperating revenue are interest income of $13,532, extended benefits of $198,445, and a federal stimulus contribution of $31,053. Total nonoperating income in 2010 was $243,030 compared to $169,660 in 2009. The increase in nonoperating income is from the federal government for extended benefits and stimulus funds provided to claimants. During fiscal year 2009, the federal government expanded its extended

(Continued)

benefits program, which enabled eligible claimants to receive several additional weeks of unemployment benefits. The federal government also provided an additional $25 dollars weekly in unemployment benefits during the year to claimants receiving regular and extended benefits; however, effective July 25, 2010, the additional $25 dollars was no longer payable on any new claims filed after that date.

Figure 1 shows the percentage of revenues received from the Fund's different sources. The largest source of revenue was from the Federal government for extended benefits, which represents 48% of total revenue.

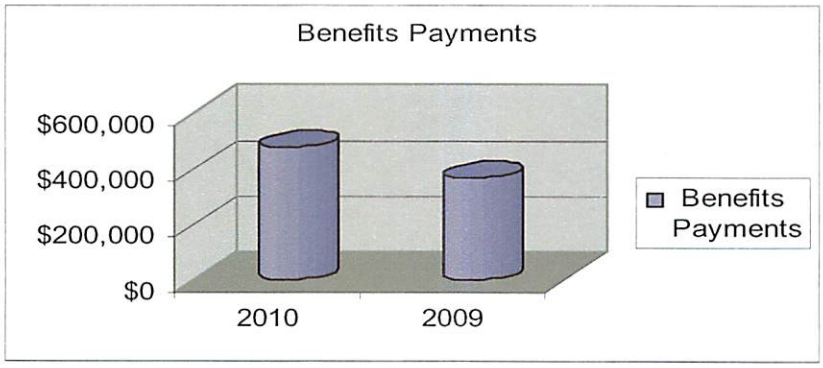
Figure 1: Total revenues (operating and nonoperating) for the year ended September 30, 2010



Expenses

The Fund's only operating expense is unemployment benefit payments. Figure 2 shows the comparison of benefits payments in 2010 and 2009.

Figure 2: Total operating expenses for the years ended September 30, 2010 and 2009



(Continued)

In fiscal year 2010, the Fund's unemployment benefits increased by $110,201 or 29.72%. This change can be attributed to an increase in the length of time claimants receive Unemployment Insurance (UI) benefits and an increase in the District of Columbia Unemployment Rate. While the number of initial claims decreased by 13% in the fiscal year 2010, the number of claimants fully exhausting the 26 weeks of UI benefits increased by 30%. The average unemployment rate was 10.9% compared to 8.9% in 2009. In fiscal year 2010, the District extended benefits three times.

Figure 3: Shows District's unemployment rate by month for the year ended September 30, 2010

	Fiscal year 2010 average				10.9%
	Month	**Labor force**	**Number of employed**	**Number of unemployed**	**Unemployment rate percentage**
CY year:					
2009	Oct	332,080	294,280	37,800	11.4%
2009	Nov	332,565	293,829	38,736	11.6
2009	Dec	332,938	293,412	39,526	11.9
2010	Jan	335,581	295,402	40,179	12.0
2010	Feb	336,407	296,433	39,974	11.9
2010	Mar	336,966	298,070	38,896	11.5
2010	Apr	337,423	300,374	37,049	11.0
2010	May	338,132	303,023	35,109	10.4
2010	Jun	337,139	303,559	33,580	10.0
2010	Jul	334,872	301,884	32,988	9.9
2010	Aug	331,846	298,995	32,851	9.9
2010	Sep	331,038	298,573	32,465	9.8

Contact Information

This financial report is designed to provide a general overview of the Fund's finances. Questions concerning any information provided in this report, or requests for additional financial information, should be addressed to the Office of the Chief Financial Officer, Government of the District of Columbia, 1350 Pennsylvania Avenue, N.W., Washington, DC 20004.

GOVERNMENT OF THE DISTRICT OF COLUMBIA
UNEMPLOYMENT COMPENSATION FUND

Statements of Net Assets

September 30, 2010
(with Comparative Totals for 2009)

(In thousands)

		2010	2009
Current assets:			
Cash held with U.S. Treasury (note 2)	$	322,826	366,403
Account receivable, net (note 3)		18,141	9,587
Due from federal government (note 4)		5,505	18,883
Total current assets	$	346,472	394,873
Current liabilities:			
Accounts payables (note 5)	$	12,579	9,301
Claimants payable (note 6)		66,952	61,028
Due to D.C. Government (note 7)		33,645	19,770
Total current liabilities	$	113,176	90,099
Net assets:			
Restricted for unemployment compensation benefits	$	233,296	304,774

See accompanying notes to financial statements.

GOVERNMENT OF THE DISTRICT OF COLUMBIA
UNEMPLOYMENT COMPENSATION FUND

Statements of Revenues, Expenses, and Changes in Net Assets

Year ended September 30, 2010
(with Comparative Totals for 2009)

(In thousands)

	2010	2009
Operating revenues:		
Employer taxes	$ 129,470	94,622
Other states' contributions	8,797	10,386
Federal contributions	9,233	12,668
District contributions	18,968	13,931
Total operating revenues	166,468	131,607
Operating expenses:		
Unemployment benefits	480,976	370,775
Total operating expenses	480,976	370,775
Operating loss	(314,508)	(239,168)
Nonoperating revenues:		
Interest revenues	13,532	18,417
Federal extended benefit contributions	198,445	127,849
Federal stimulus contributions	31,053	23,394
Total nonoperating revenues	243,030	169,660
Change in net assets	(71,478)	(69,508)
Total net assets – beginning	304,774	374,282
Total net assets – ending	$ 233,296	304,774

See accompanying notes to financial statements.

GOVERNMENT OF THE DISTRICT OF COLUMBIA
UNEMPLOYMENT COMPENSATION FUND

Statements of Cash Flows

Year ended September 30, 2010
(with Comparative Totals for 2009)

(In thousands)

		2010	2009
Cash flows from operating activities:			
Cash receipts from employers	$	123,399	95,779
Cash receipts from federal government		9,233	12,652
Cash receipts from district government		15,482	15,086
Cash receipts from other states		9,800	7,099
Cash payments to claimants		(475,173)	(345,847)
Net cash used in operating activities		(317,259)	(215,231)
Cash flows from investing activities:			
Interest income received		13,532	18,417
Net cash provided by investing activities		13,532	18,417
Cash flows from noncapital financing activities:			
Federal extended benefit contributions		211,823	113,623
Federal stimulus contributions		31,053	18,751
Federal government reed act contributions		18,422	11,185
District reed fund payments		(1,148)	(3,141)
Net cash provided by noncapital financing activities		260,150	140,418
Net decrease in cash equivalents		(43,577)	(56,396)
Cash, beginning of year		366,403	422,799
Cash, ending of year	$	322,826	366,403
Reconciliation of operating loss to net cash used in operating activities:			
Operating loss	$	(314,508)	(239,168)
Increase in assets:			
Receivables		(8,554)	(1,994)
Increase in liabilities:			
Payables		5,803	25,931
Net cash used in operating activities	$	(317,259)	(215,231)

See accompanying notes to financial statements.

(1) Nature of Activities and Summary of Significant Accounting Policies

(a) Nature of Activities

Pursuant to federal law, the Government of the District of Columbia (the District) maintains an Unemployment Compensation Fund (the Fund). The Fund pays up to 26 weeks of regular statutory benefits to eligible unemployed former employees of the District of Columbia or the federal government. The Fund also pays additional weeks of benefits to eligible claimants who have exhausted their regular 26 weeks of benefits.

The Fund is funded by employer taxes and reimbursements from governmental agencies for regular unemployment benefits paid to former employees and by the federal government for extended benefits paid to eligible claimants.

The Fund is administered by the Director of the District's Department of Employment Services. Substantially all administrative costs of the program are paid by a federal grant, which is recorded in the District's General Fund. These financial statements present only assets, liabilities, revenues, and expenses of the Fund and are not intended to present the financial position and results of operations of the Government of the District of Columbia taken as a whole.

(b) Basis of Presentation

The Fund's financial statements are presented in accordance with U.S. generally accepted accounting principles (GAAP) as promulgated by the Governmental Accounting Standards Board (GASB).

(c) Basis of Accounting

The accompanying financial statements are prepared on the accrual basis of accounting. Under this accounting method, all revenues are recognized when earned and expenses are recognized as incurred in the production of that revenue.

The Fund has elected, as allowed in paragraph 7 of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund Accounting*, not to follow Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principle Board Opinions, and Accounting Research Bulletins of the Committee of Accounting Procedure issued subsequent to November 30, 1989. The Fund applies all applicable FASB pronouncements issued on or prior to November 30, 1989 in accounting for and reporting its operations, unless these pronouncements conflict with GASB pronouncements.

(d) Measurement Focus

The financial statements are accounted for on a flow of economic resources measurement focus, wherein all assets and liabilities are included in the Statement of Net Assets. The related statement of revenue, expenses, and changes in net assets presents increases (revenues) and decreases (expenses) in net assets.

(e) Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(2) Cash Held with U.S. Treasury

The Fund's cash is held at the U.S. Department of Treasury (the Treasury) in a trust fund in the District's name. Pursuant to the Social Security Act, the funds held at the Treasury earn interest quarterly based on the interest rates of the Treasury's Certificates of Indebtedness. Interest earned in 2010 and 2009 was $13,532 and $18,417, respectively. At September 30, 2010, cash held at the Treasury was $322,826 compared to $366,403 at September 30, 2009.

(3) Accounts Receivable

The Fund's accounts receivable consist of the following at September 30, 2010 and 2009:

	2010	2009
Employer receivables	$ 13,904	9,167
Claimant receivables	14,151	5,596
Due from other funds/states	2,135	5,092
Total receivables	30,190	19,855
Less allowance for doubtful accounts	(12,049)	(10,268)
Net accounts receivable	$ 18,141	9,587

Employer contributions are recognized as revenues in the accounting period in which they become due and measurable. Any contributions not received within the accounting period are recognized as Employer Receivables. Claimants receivable are benefits paid to claimants who ultimately are proven to be ineligible to receive all or a portion of those benefits. The Fund recognizes a receivable from these claimants when the benefits overpayment is identified. Due from other funds at September 30, 2010 is the amount owed to the Fund from the District. Aging of the receivables is used to estimate and establish an allowance for doubtful accounts. Receivables other than claimant receivables over two years old and claimant receivables over 450 days old are recorded as an allowance for doubtful accounts as well as claimants receivables over 450 days old.

(4) Due from Federal Government

The federal government reimburses the Fund for extended benefits paid to eligible claimants who have exhausted their 26 weeks of regular benefits. Under the American Recovery and Reinvestment Act of 2009 (stimulus funds), the federal government also provided an additional $25 dollars in weekly unemployment benefits to claimants receiving regular and extended benefits; however, effective July 25, 2010, the additional $25 dollars was no longer payable on any new claims filed after that date. At September 30, 2010 and 2009, the estimated amount owed from the federal government for extended benefits and stimulus funds expected to be paid on claims filed during the respective fiscal years was $5,505 and $18,883.

(5) Accounts Payable

At September 30, 2010 and 2009, the Fund had payables to employers for taxes overpaid, various states for unemployment benefits paid to former District employees, and others for Fund-related activities:

		2010	2009
Employer tax refund payable	$	3,131	3,264
Income tax payable		3,792	—
Due to other states		3,873	5,787
Others		1,783	250
Total accounts payable	$	12,579	9,301

(6) Claimants Payable

Claimants Payables are estimated amounts due to claimant for the remaining periods of eligibility that are payable the following fiscal year. The claimant payables as of September 30, 2010 and 2009 were $66,952 and $61,028, respectively.

(7) Due to D.C. Government

The amounts reported as "Due to D.C. Government" consist of Reed Act funds obligated for administrative costs, and interest and penalties assessed and collected from employers for late tax payments but not yet paid to the District. The amounts payable to the District as of September 30, 2010 and 2009 are $33,645 and $19,770, respectively.

(8) Commitments and Contingencies

At September 30, 2010, there were no matters of litigation involving the Unemployment Compensation Fund or which would materially affect the Unemployment Compensation Fund's financial position should any court decisions on pending matters not be favorable to the Fund.

KPMG LLP
2001 M Street, NW
Washington, DC 20036-3389

Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Mayor and the Council of the Government of the District of Columbia
Inspector General of the Government of the District of Columbia:

We have audited the financial statements of the Government of the District of Columbia Unemployment Fund (the Fund) as of and for the year ended September 30, 2010, and have issued our report thereon dated February 16, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Fund's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

A deficiency in internal control over financial reporting 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 combination of deficiencies, in internal control over financial reporting, 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. We consider the deficiencies in the Fund's internal control over financial reporting described in the Appendix A to be material weaknesses.

KPMG LLP is a Delaware limited liability partnership, the U.S. member firm of KPMG International Cooperative ("KPMG International"), a Swiss entity.

KPMG

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

The Fund's responses to the findings identified in our audit are described in the accompanying Appendix A. We did not audit the Fund's responses, and accordingly, we express no opinion on them.

This report is intended solely for the information and use of management, the Mayor, Members of the Council and the Inspector General of the Government of the District of Columbia, others within the entity, and the U.S. Department of Labor, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

February 16, 2011

Appendix A

GOVERNMENT OF THE DISTRICT OF COLUMBIA
UNEMPLOYMENT COMPENSATION FUND

Material Weakness in Internal Control
Over Financial Reporting

September 30, 2010

Material Weakness Number 1: Lack of Effective Controls over Financial Reporting

Condition

We identified the following control weaknesses over the Department of Employment Services Unemployment Compensation Fund (DOES)'s financial reporting process:

During performance of our substantive audit procedures over the fiscal year end general ledger balance, we noted an error recorded in the year-end accounts receivable balance in the form of an approved adjusting journal entry recording an accounts receivable for $59 million; however, this entry was in error as the amounts were included in the Fund's cash balance at September 30, 2010. This error was not detected during the management review and approval of the journal entry prior to being posted to the general ledger.

We also noted that an appropriate level of management review and monitoring over the financial statement reporting process was not adequately performed prior to submission to us for testwork. We identified incomplete and inaccurate financial statements as indicated by the following:

- The Fund's initial draft financial statements did not include relevant and required financial statement disclosures in accordance with U.S. generally accepted accounting principles (GAAP);
- Prior year amounts reported on the September 30, 2010 statement of cash flow could not be agreed to the certain prior year audited cash flow statement amounts; and
- The Fund's initial draft financial statements did not include the required Management's Discussion and Analysis (MD&A) information related to an analysis of the financial activities of the reporting entity based on currently known facts, decisions or conditions and comparisons of amounts between the current and prior year or an analysis of the overall financial position and results of operations.

Criteria

Governmental Accounting Standards Board (GASB) Statement No. 1, *Objectives of Financial Reporting*, recognizes the basic characteristics of financial reporting objectives as understandability, reliability, relevance, timeliness, consistency, and comparability. While GASB does not identify specific control standards, state and local governments follow internal control guidance to meet those objectives. Two of the major sources of guidance for state and local governmental units related to auditing and reporting on internal control are the Single Audit Act and *Government Auditing Standards* (GAS), also known as generally accepted *Government Auditing Standards* (GAGAS), and popularly known as the Yellow Book. These standards are produced by the Government Accountability Office. GAO's Standards for Internal Control states that for an entity to run and control its operations, it must have relevant, reliable, and timely communications relating to internal as well as external events. Information is needed throughout an agency to achieve all of its objectives. These standard control activities help to ensure that all transactions are completely and accurately recorded and reported.

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GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Government*, paragraph 6 states in part, the minimum requirements for MD&A, basic financial statements, and required supplementary information other than MD&A as follows:

(1) Management's discussion and analysis

(2) Basic financial statements should include:

a. Fund financial statements (required proprietary fund statements are a statement of net assets; a statement of revenues, expenses, and changes in fund net assets; and a statement of cash flows).

b. Notes to the financial statements.

(3) Required Supplementary information other than MD&A.

The Fund's required fund statements are a statement of net assets; a statement of revenues, expenses, and changes in fund net assets; and a statement of cash flows.

GAAP also outlines the required information to be included in MD&A, which states. MD&A should provide an objective and easily readable analysis of the government's financial activities based on currently known facts, decisions, or conditions. MD&A should include comparisons of the current year to the prior year based on the financial statement information. It should provide an analysis of the government's overall financial position and results of operations to assist users in assessing whether that financial position has improved or deteriorated as a result of the year's activities. In addition, it should provide an analysis of significant changes that occur in funds and significant budget variances. MD&A should conclude with a description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations.

Cause

DOES has not implemented a comprehensive set of financial reporting policies and procedures, which includes an appropriate level of management review to ensure effective controls over the accurate processing and recording of financial transactions and financial statement preparation.

Effect

A lack of effective controls over the financial recording and reporting of transactions, which includes appropriate levels of management review, may result in incomplete and inaccurate financial data recorded and reported in the financial statements. In addition, without the proper level of management review over the financial statement preparation process, the financial statements may not be presented in accordance with GAAP and other relevant accounting and reporting standards.

Recommendation

We recommend DOES management implemented and consistently follow policies and control procedures over financial reporting to ensure completeness and accuracy of the financial statements. DOES should provide

training regarding these policies to those employees responsible for the recording and reporting of financial information and monitor the effectiveness of the control procedures to ensure they are consistently implemented.

Management's Response

The initial draft of the UI Financial was inadvertently sent to KPMG without the benefits of exhausting all level of management control and review. As pertaining to the $59 million receivable, after further financial statement analysis, management realized that the initial assumption made for recording the receivable amount was incorrect and the entry was reverse accordingly.

Management will continue to strength internal control as it is related to review of the financial statements, specifically focusing on financial statements disclosure, to ensure that all draft financial statement are properly disclose in accordance with GAAP the U.S. Generally Accepted Accounting Principles. In addition, management will provide training to employees responsible for preparation and financial statement review to ensure that the financial statements are presented in accordance with GAAP and other relevant accounting standards.

Material Weakness Number 2: Ineffective General Information Technology Controls

User Access Review for BARTS, DOCS, and DUTAs

Condition

Management informed us that a review of user access was performed for all applications in June 2010 and submitted a user listing of personnel with access to DUTAS at the database and operating system levels and indicated the listing was evidence of a portion of the June 2010 reviews. However, signed review sheets representing the formal completion of the reviews were not available for inspection. Further, we noted that DOCS and DUTAs user access lists generated in September 2010 contained user access rights listed that should have been removed as a result of a review performed in June 2010.

Management performed user access reviews of BARTS, DOCS, and DUTAs in October 2010 upon our request and submitted documentation of those reviews for inspection. Based on a review of the documentation provided, we noted that management performed actions to remove the DOCS user access considered inappropriate based on our review of the access list generated in September 2010. We also noted that the BARTS and DUTAs reviews indicated management did not note any instances of inappropriate access as a result of their review.

Criteria

National Institute of Standards and Technology (NIST) Special Publication (SP) 800-12, *An Introduction to Computer Security*: *The NIST Handbook*, October 1995, states:

"From time to time, it is necessary to review user account management on a system. Within the area of user access issues, such reviews may examine the levels of access each individual has, conformity with the concept of least privilege, whether all accounts are still active, whether management authorizations are up-to-date, whether required training has been completed, and so forth.

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These reviews can be conducted on at least two levels: (1) on an application-by-application basis, or (2) on a system wide basis. Both kinds of reviews can be conducted by, among others, in-house systems personnel (a self-audit), the organization's internal audit staff, or external auditors. For example, a good practice is for application managers (and data owners, if different) to review all access levels of all application users every month and sign a formal access approval list, which will provide a written record of the approvals. While it may initially appear that such reviews should be conducted by systems personnel, they usually are not fully effective. System personnel can verify that users only have those accesses that their managers have specified. However, because access requirements may change over time, it is important to involve the application manager, who is often the only individual in a position to know current access requirements."

Cause

From October 2009 through May 2010, management did not have a formalized periodic access review process for the entire DOCS, DUTAS, and BARTS user community. In addition, turnover of key IT management members during March 2010 and May 2010 resulted in improper application of processes controls including the performance of periodic user access reviews.

However, we noted that DOES appointed a new CIO in May 2010, at which time the need to perform reviews of application user access was identified. The access reviews performed in June 2010 and October 2010 reflected management's efforts to implement this control.

Effect

A lack of review of user accounts on a regular basis to determine whether access levels are appropriate for a given user's job responsibilities and to verify that all user accounts belong to current employees, may result in the following risks:

- Employees may have access to a system that does not correspond with their current job responsibilities and/or may present a conflict of interest. This access could allow a person to intentionally or unintentionally alter the integrity of application data in an unauthorized manner.
- Should an active user account of a separated employee be present within the application, the separated person, with malicious intent, or another person with knowledge of this active user account, may have the ability to use this account to alter the integrity of application data in an unauthorized manner.

In addition, the lack of formalized user access review documentation requirements increases the risk that reviews will be performed and documented inconsistently and management and other interested parties will not have reliable audit trails of review activities.

Recommendation

We recommend that management institute a formalized, periodic review process to determine whether BARTS, DOCS, and DUTAs user access remains commensurate with employee job responsibilities.

In addition, management should develop and formally document procedures for performing reviews that address mandatory review steps, follow-up procedures for any exceptions identified, and documentation retention requirements. Management should provide training on this policy to those responsible for performing these procedures and monitor the review controls in place to ensure adherence to the policy.

Management Response

Management does concur with this finding. Documentation was provided to support the initial review of user access lists in June 2010, but we were not able to provide the requested sign-off sheets for this first formalized review. Regarding the user access reviews performed in the fall, it should be noted that this is a semiannual review process. The next scheduled time for review is December 2010, but at the request of KPMG, we incorporated an additional review in October. At this time, we noted user access considered to be inappropriate, and removed such access. In addition, we did provide the documentation regarding the completed DUTAS access review. All of these reviews, and the subsequent modification and/or removal of access would have been performed during the semiannual review in December, as planned.

DOCS User Access

Condition

During the months of August and September 2010, the DOCS business owner applied user access changes directly to accounts in the application instead of forwarding their approved user access requests to the security administrator for configuration.

However, we noted that in October 2010, DOES IT management performed a DOCS user access review and indicated that although the DOCS business owner did not follow the established process, the access changes that she made were proper in consideration of the users' job responsibilities and "need-to-know."

Criteria

National Institute of Standards and Technology (NIST) Special Publication (SP) 800-12, *An Introduction to Computer Security*: *The NIST Handbook*, October 1995, states:

"User account management involves (1) the process of requesting, establishing, issuing, and closing user accounts; (2) tracking users and their respective access authorizations; and (3) managing these functions.

User account management typically begins with a request from the user's supervisor to the system manager for a system account. If a user is to have access to a particular application, this request may be sent through the application manager to the system manager. This will ensure that the systems office receives formal approval from the "application manager" for the employee to be given access. The request will normally state the level of access to be granted, perhaps by function or by specifying a particular user profile. (Often when more than one employee is doing the same job, a "profile" of permitted authorizations is created.)

Systems operations staff will normally then use the account request to create an account for the new user. The access levels of the account will be consistent with those requested by the supervisor. This account will normally

be assigned selected access authorizations. These are sometimes built directly into applications, and other times rely upon the operating system. "Add-on" access applications are also used. These access levels and authorizations are often tied to specific access levels within an application."

Cause

DOES management has not finalized the draft process/procedures document that outlines requirements for requesting, approving, and configuring DOCS user access. As such, the procedures have not been communicated to the responsible DOES personnel at the time or our audit.

Effect

Without a finalized user access control procedures, there is an increased risk that access control procedures will be performed inconsistently, if at all, and, as a result, users may obtain/retain inappropriate access to information systems. This access may allow a person to intentionally or unintentionally alter the integrity of the application and its data in an unauthorized manner.

Recommendation

We recommend that management finalize its draft access management policy and procedures for the DOCS production application. The finalized policy/procedures should include, at a minimum, procedural and documentary requirements for requesting, approving, and configuring user accounts. Management should provide training on this policy to those responsible for performing these control procedures and monitor the application of those procedures to ensure adherence to the policy.

Management Response

Management concurs with this finding. KPMG has acknowledged that DOES has an established process for user access review and access granting, and has not cited further instances of user access being granted outside the established protocols. From the criteria you provided, "User account management typically begins with a request from the user's supervisor to the system manager for a system account." In this instance, the user who granted the access (User #1) was the manager of the division, and the supervisor of the manager (User #2) to whom access was granted. As User #2 already had access to the system, this was an add-on request for which initial system authorization had been granted.

Program Change Control Procedures for BARTS, DOCS and DUTAs

Condition

DOES management has instituted a process whereby BARTS, DOCS, and DUTAs program changes are discussed and approved during weekly change management meetings and documented in weekly status reports. For the period October 1, 2009 through July 31, 2010, management had not instituted formal procedures to document program change descriptions, approvals and the performance of change testing. As a result, prior to August 2010, management did not consistently document program change descriptions, approvals, or testing activities for DOCS and DUTAS.

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We were informed that only one BARTS application deployment was implemented into the production environment during fiscal year 2010. We noted an associated change approval form and an e-mail documenting user acceptance test success were retained for this change. However, we considered documentation of testing provided insufficient to evidence the performance of user acceptance testing procedures and associated results.

Further, a DOES Project Implementation Approval form used to document the effective date, description of change was not available for inspection because it had not yet been required by DOES during the initiation of the BARTS application deployment project. However, we did review a communication sent by the DC Department of Health documenting the pre-implementation approval of the project.

Criteria

National Institute of Standards and Technology (NIST) Special Publication (SP) 800-64, *Security Considerations in the System Development Life Cycle*, October 2008, Section 3.3 SDLC Phase: Implementation/Assessment, provides potential "control gates" related to the Implementation/Assessment phase of the Systems Development Life Cycle (SDLC), including:

- "System Test Readiness Review
- Certification and Accreditation (C&A) Review
- Final Project Status and Financial Review
- Deployment Readiness Review
- Authorizing Official (AO) Decision
- IT Deployment or Connection Approval"

This section goes on to describe recommended outputs from this phase that serve to formally document the activities described above.

Cause

Management's change control process does not include requirements for the minimum required documentation to evidence the completion of test activities. Additionally, the DOES Project Implementation Approval form had not yet been required by DOES at the time when the BARTS application deployment project began (after which the form's completion was required).

Effect

Lack of complete and formalized change control procedures for completing and documenting testing activities can increase the risk that unauthorized and/or potentially unintended program changes may be implemented into the production environment, which may result in a loss of application program integrity and/or data being processed incorrectly.

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Recommendation

We recommend that management enhance its current change management policies and procedures, which at a minimum include procedural and documentary requirements for:

- The completion of a formal change request form(s);
- Authorization of the change prior to initiation of the work;
- The minimum requirements for performing and documenting testing to determine whether the change is operating as required;
- Formal approval of the change prior to migration to production; and
- Monitoring controls to assess the completeness and accuracy of manual change control listings maintained by management.

Management Response

Management does concur with this finding. Since the integration of the change to BARTS mentioned above, the process for implementing system changes has been put in place. While this process is in place, management is continuing to formally document this process, as well as thoroughly train incoming staff – both UI and IT.

Segregation of Duties – DOCS and DUTAs Developers

Condition

Two of seven DOCS developers and all of the DUTAs developers (two individuals) have access to the production environment and the ability to migrate DOCS and DUTAs program code into production. In addition, management has not implemented other mitigating change management controls.

Management does not have an independently operated control to monitor and document the activities of developers that have access to the production environment. Management informed us that it has instituted an informal peer review process whereby the four developers referenced above split the responsibilities for change development and review/migration such that no changes are developed and implemented by the same individual within each system; however, documented evidence of the peer review was not available for our review.

Criteria

National Institute of Standards and Technology (NIST) Special Publication (SP) 800-53, Revision 3, *Recommended Security Controls for Federal Information Systems and Organizations*, August 2009, section Access Control (AC-5) states:

"The organization:

(a) Separates duties of individuals, as necessary, to prevent malevolent activity without collusion;

(b) Documents separation of duties; and

(c) Implements separation of duties through assigned information system access authorizations.

Examples of separation of duties include: (i) mission functions and distinct information system support functions are divided among different individuals/roles; (ii) different individuals perform information system support functions (e.g., system management, systems programming, configuration management, quality assurance and testing, and network security); (iii) security personnel who administer access control functions do not administer audit functions.

GAO's *Standards for Internal Control in the Federal Government*, November 1999, states "Key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud...No one individual should control all key aspects of a transaction or event."

Cause

Management has not segregated the responsibilities for performing program development and migrating changed code to the production environment between two or more individuals. Management considers the current change controls, including above-noted developer peer reviews, as an interim solution to help mitigate the risks related to the developers' possession of access to the production environment.

Effect

The lack of proper change management controls increases the risk that users with administrative level access may apply changes to application programs and data that have adverse effects on the availability or processing/data integrity of the application without management's awareness or approval.

Recommendation

We recommend that management develop and implement change management processes and controls that establish one or more of the following:

- Organizational and logical segregation of program development roles from production system administration roles among different individuals,
- Implementation of one or more independently operated monitoring controls over the activities of the developers (and other individuals) with access to the production environment that require the documentation of monitoring activities as well as follow up on any suspicious behavior within the system, and/or
- Management should provide training on this policy to those responsible for performing these procedures and monitor the application of controls to ensure adherence to the policy.

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Management Response

Management does concur with this finding; however, there are three DUTAS developers and two have access to migrate changes to production. Additionally management is in the process of adding additional staff to fully implement best practices of separation of duties.

User Access Authorization Forms – BARTS

Condition

During testing to evaluate the BARTS access authorization process we noted the following related to two of three user accounts created for BARTS in fiscal year 2010:

- For one out of the three user accounts noted above, management was unable to provide documentation of the second approver's authorization for access.
- For one out of the three user accounts noted above, management was unable to provide the signed user access form as required by the DOES process.

We further noted that in October 2010, DOES management performed user access reviews and indicated that although documentation evidencing the supervisory approval was unavailable for one of the three users, the corresponding access granted was nevertheless authorized in consideration of job responsibilities and the users' need-to-know.

Criteria

National Institute of Standards and Technology (NIST) Special Publication (SP) 800-12, *An Introduction to Computer Security*: *The NIST Handbook*, October 1995, states:

"User account management involves (1) the process of requesting, establishing, issuing, and closing user accounts; (2) tracking users and their respective access authorizations; and (3) managing these functions.

User account management typically begins with a request from the user's supervisor to the system manager for a system account. If a user is to have access to a particular application, this request may be sent through the application manager to the system manager. This will ensure that the system's office receives formal approval from the "application manager" for the employee to be given access. The request will normally state the level of access to be granted, perhaps by function or by specifying a particular user profile. (Often when more than one employee is doing the same job, a "profile" of permitted authorizations is created.)

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Systems operations staff will normally then use the account request to create an account for the new user. The access levels of the account will be consistent with those requested by the supervisor. This account will normally be assigned selected access authorizations. These are sometimes built directly into applications, and other times rely upon the operating system. "Add-on" access applications are also used. These access levels and authorizations are often tied to specific access levels within an application."*Cause*

Management has not consistently followed the formalized user access control process that establishes procedural and documentation requirements for requesting, approving, configuring, and periodically reviewing user access modifications in the DOES production applications.

Effect

A lack of a formally documented user access control process, may increase the risk that access control procedures will be performed inconsistently, if at all, and, as a result, users may obtain/retain inappropriate access to information systems and intentionally or unintentionally alter the integrity of the application and its data in an unauthorized manner.

Recommendation

We recommend that management develop and formally document the access control policy and related procedures for the DOES production applications. We recommend that these include, at a minimum, procedural and documentary requirements for:

- Requesting, approving and configuring user accounts, and
- Periodic reviews of user access performed in consideration of users' ongoing need to retain BARTS access and segregation of duties considerations, and the configuration of any updates required as a result of inappropriate access identified during the review process.

Management Response

Management does concur with this finding. In one of three user access accounts noted above, management provided verbal secondary approval for an access change. We have since instituted a policy that allows for e-mail approval by appropriate management remotely when necessary. Regarding the implied approval highlighted above, management has since instituted a policy that approvals must always be explicitly stated in writing. When access to official approval documentation is not available when management is physically unavailable, approval may be provided from a secure e-mail account assigned only to said management. Upon management returns, documents must be completed, signed, and attached to approval email.