

Department of the Treasury

**For the Year Ended
June 30, 2001**

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

January 11, 2002

Members of the General Assembly
and
The Honorable Steve Adams, Treasurer
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of the Treasury for the year ended June 30, 2001.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies which are detailed in the Results of the Audit section of this report. The department's management has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/mb
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State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Department of the Treasury
For the Year Ended June 30, 2001

AUDIT OBJECTIVES

The objectives of the audit were to consider the Department of the Treasury's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Flexible Benefits Plan, the Baccalaureate Education System Trust-Educational Services Plan, the State Pooled Investment Fund, and the Bond Refunding Trust; to determine compliance with certain provisions of laws, regulations, contracts, and grants; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDINGS

The Department of the Treasury should develop and implement written procedures related to the preparation and use of credit analysis reports that support the purchase of commercial paper

The investment policies of the State Pooled Investment Fund require the Department of the Treasury to prepare a credit analysis report on a corporation before the department purchases that corporation's commercial paper. However, guidance on certain aspects of preparing and using the reports is lacking. One directive needed is how often credit analysis reports should be updated. Other guidance needed is how the decision to purchase commercial paper contrary to the recommendation in the credit analysis report should be documented (page 10).

The Collateral Pool Board and the Department of the Treasury should ensure that annual, quarterly, and monthly reports required from participating financial institutions are received and reviewed

The required annual, quarterly, and monthly reports from financial institutions are used to determine if the institutions have reported all public deposits held and pledged sufficient collateral for the public deposits held. However, some required reports are not being received, are not received by the due

date, or are not properly completed. It appears that the department lacks adequate enforcement procedures to ensure that required reports are completed and submitted to the department. Also, the department needs to review the annual reports to determine that the appropriate person completes them (page 11).

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, please contact

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Audit Report
Department of the Treasury
For the Year Ended June 30, 2001

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Department of the Treasury For the Year Ended June 30, 2001

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Department of the Treasury. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The State Treasurer, a constitutional officer, is elected by a joint session of the General Assembly for a two-year term. Although no duties are prescribed by the constitution, the functions and duties of the office are assigned through various statutes. These functions and duties include maintaining accountability for and management of public funds and administering the Tennessee Consolidated Retirement System, the Local Government Investment Pool, the Uniform Disposition of Unclaimed Property Act, the Criminal Injuries Compensation Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust, and the state’s Deferred Compensation and Flexible Benefits Plans. The Treasurer also administers the settlement of claims against the state through the Tennessee Claims Commission and the Division of Claims Administration.

The Treasurer is required by statute to be a member of many boards and commissions, including the following:

Board of Equalization
Board of Trustees of the Tennessee Consolidated Retirement System
Funding Board
Public Records Commission
State Building Commission
State Insurance Committee
State School Bond Authority

Tennessee Competitive Export Corporation
Tennessee Housing Development Agency
Tennessee Local Development Authority
Tennessee Student Assistance Corporation

ORGANIZATION

The department is divided into ten major sections: Staff Services, Investments, Baccalaureate Education System Trust (BEST), Information Systems, Administrative Services, Tennessee Consolidated Retirement System (TCRS), Accounting, Unclaimed Property, Claims Administration, and Risk Management. The TCRS is audited and reported on separately.

The **Staff Services** section includes personnel administration, budgeting and fiscal control, research and development of special projects, internal audit, and legal services.

The **Investments** section invests the pension fund to maximize the return on investments and to protect the retirement system's assets. This section also invests the state's available cash in certificates of deposit in state depositories, prime commercial paper, prime bankers' acceptances, certain repurchase agreements, various U.S. Treasury and agency obligations, and certain obligations of the State of Tennessee.

The **BEST** section is responsible for the operation of the state's prepaid college tuition plan (Educational Services Plan) and college savings plan (Educational Savings Plan).

The **Information Systems** section provides the department with data processing services, and **Administrative Services** provides centralized services, including physical facilities management, forms control and copying, safekeeping, remittance receiving, and operation of the Federal Reserve wire transfer facility used to send, receive, and transfer funds for the State Trust of Tennessee.

The **Accounting** section is responsible for maintaining detailed accounting records for various programs administered by the department. This includes maintaining general ledger accounting and reporting for the Tennessee Consolidated Retirement System, the Chairs of Excellence Program, the Local Government Investment Pool, the Cash Management Investment Program, the Claims Award Fund, the Criminal Injuries Compensation Fund, the Flexible Benefits Plan, the Baccalaureate Education System Trust, and the Bond Refunding Trust. The section is also responsible for reconciling approximately 150 bank accounts and maintaining the state's warrant reconciliation system (Account Reconciliation Package, or ARP).

The **Unclaimed Property** section takes custody of abandoned property (bank accounts, insurance policies, etc.) and attempts to locate the rightful owners or heirs. The Division of **Claims Administration** administers the Workers' Compensation program for state employees and the Criminal

Injuries Compensation Fund. The division reviews and determines eligibility for payment from the Criminal Injuries Compensation Fund. Payments are made as funds become available.

The **Risk Management** section administers a variety of insurance programs for the state. These programs provide protection to the state against property damage, boiler explosion, and employee dishonesty.

An organization chart of the department is presented on the following page.

AUDIT SCOPE

The audit was limited to the period July 1, 2000, through June 30, 2001, and was conducted in accordance with government auditing standards generally accepted in the United States of America.

The Department of the Treasury is part of the primary government of the State of Tennessee and is accounted for in the general fund. The department administers the Tennessee Consolidated Retirement System, pension trust funds; the Criminal Injuries Compensation Fund, a special revenue fund; the Claims Award Fund, an internal service fund; the Chairs of Excellence Fund, a nonexpendable trust fund; the Baccalaureate Education System Trust-Educational Services Plan and the Flexible Benefits Plan, expendable trust funds; the State Pooled Investment Fund, an external investment pool (which includes the Local Government Investment Pool); and the Bond Refunding Trust, an agency fund.

This audit included all of the above funds except for the Tennessee Consolidated Retirement System, which is reported on in a separate audit report. The following allotment codes within the State of Tennessee Accounting and Reporting System were covered by this audit:

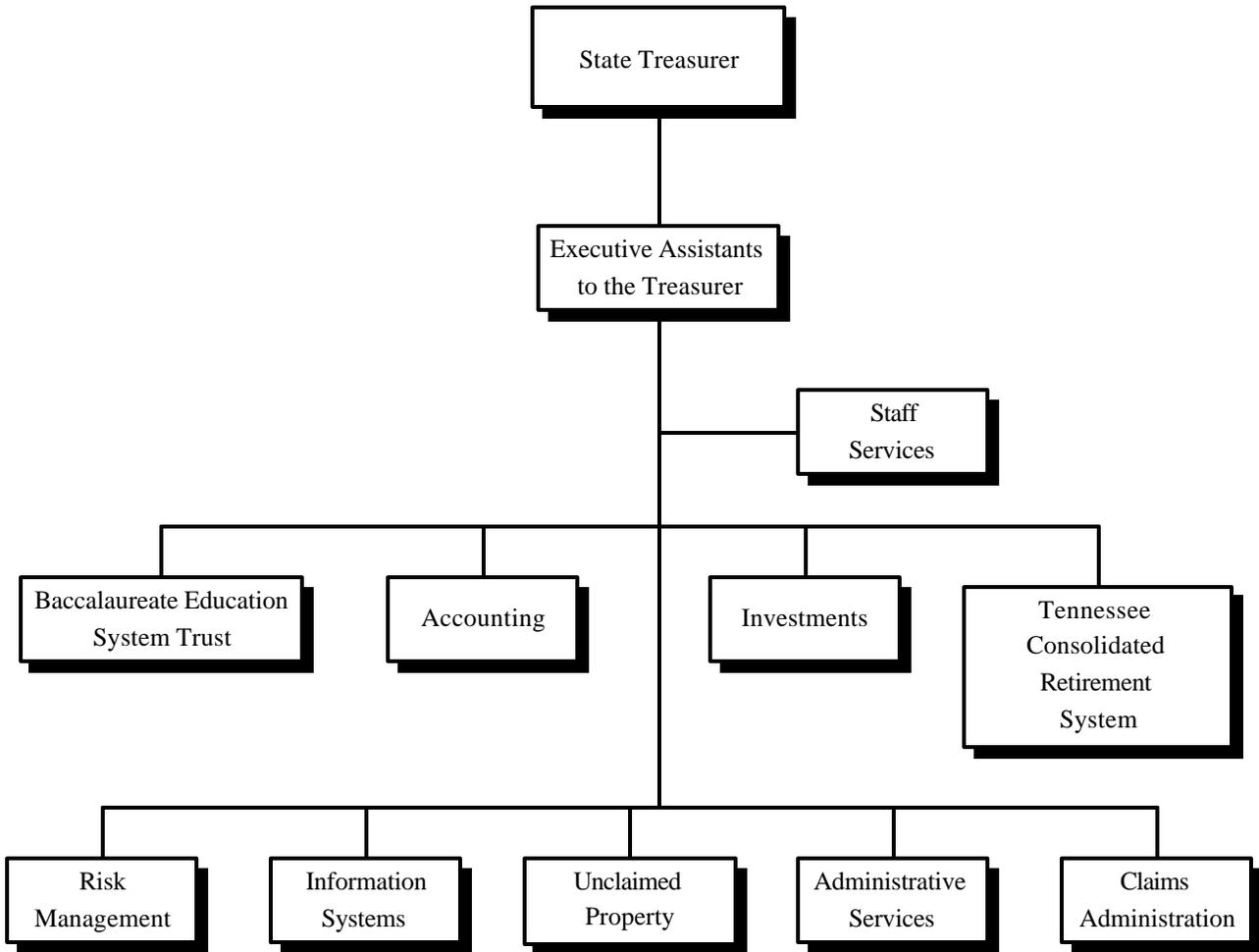
State Treasurer's Office	309.01
Criminal Injuries Compensation	313.03
Claims Award Fund	313.10
Unclaimed Property	313.20

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the Department of the Treasury's internal control over financial

**DEPARTMENT OF THE TREASURY
ORGANIZATION CHART**



reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust-Educational Services Plan, the Flexible Benefits Plan, the State Pooled Investment Fund, and the Bond Refunding Trust;

2. to determine compliance with certain provisions of laws, regulations, contracts, and grants; and
3. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, it included tests of compliance with applicable federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by each June 30. The Department of the Treasury filed its compliance report and implementation plan on September 20, 2001.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or national origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Human Rights Commission is the coordinating state agency for the monitoring and enforcement of Title VI. A summary

of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report *Submission of Title VI Implementation Plans*, issued annually by the Comptroller of the Treasury.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust-Educational Services Plan, the Flexible Benefits Plan, the State Pooled Investment Fund, and the Bond Refunding Trust for the year ended June 30, 2001, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by government auditing standards generally accepted in the United States of America. Reportable conditions, along with recommendations and management's responses, are detailed in the findings and recommendations. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.



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COMPTROLLER OF THE TREASURY
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**Report on Compliance and on Internal Control
Over Financial Reporting Based on an Audit of
Financial Statements Performed in Accordance With
*Government Auditing Standards***

December 4, 2001

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Criminal Injuries Compensation Fund, the Claims Award Fund, the Chairs of Excellence Fund, the Baccalaureate Education System Trust-Educational Services Plan, the Flexible Benefits Plan, the State Pooled Investment Fund, and the Bond Refunding Trust as of and for the year ended June 30, 2001, and have issued our reports thereon dated December 4, 2001. As discussed in Note A.5. to the financial statements of the State Pooled Investment Fund, the fund changed its method of accounting for the issuance of warrants, checks, and automated clearing house payments. Also, as discussed in Note A.7. to the financial statements of the Chairs of Excellence Fund and in Note A.6. to the financial statements of the Baccalaureate Education System Trust-Educational Services Plan, the State of Tennessee changed its definition of cash and cash equivalents. We conducted our audit in accordance with government auditing standards generally accepted in the United States of America. The Department of the Treasury and the funds it administers are part of the primary government of the State of Tennessee.

Compliance

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the department's compliance with certain provisions of laws, regulations, contracts, and grants, 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 that are required to be reported under *Government Auditing Standards*.

We did, however, note certain less significant instances of noncompliance, which we have reported to the department's management in a separate letter.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable conditions were noted:

- The Department of the Treasury should develop and implement written procedures related to the preparation and use of credit analysis reports that support the purchase of commercial paper.
- The Collateral Pool Board and the Department of the Treasury should ensure that annual, quarterly, and monthly reports required from participating financial institutions are received and reviewed.

These conditions are described in the Findings and Recommendations section of this report.

A material weakness is a condition 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to the department's management in a separate letter.

The Honorable John G. Morgan
December 4, 2001
Page Three

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/mb

FINDINGS AND RECOMMENDATIONS

1. **The Department of the Treasury should develop and implement written procedures related to the preparation and use of credit analysis reports that support the purchase of commercial paper**

Finding

The State Funding Board establishes investment policies of the State Pooled Investment Fund. Those policies require the Department of the Treasury to prepare a credit analysis report on a corporation before the department purchases that corporation's commercial paper. The credit analysis report is to include a company profile, business description, financial profile, rating information, strengths and opportunities, weaknesses and threats, and an outlook and recommendation.

The department began preparing the credit analysis reports shortly before the amendment to the investment policies requiring the preparation of these reports was approved in March of 2001. However, guidance on certain aspects of preparing and using the reports is lacking. One directive needed is how often credit analysis reports should be updated. Reports for some corporations have not been updated to reflect the most recent financial information. The latest financial information on these corporations was from December 1999. As of December 4, 2001, these reports had not been updated for 2000, although the department was still making frequent acquisitions of these corporations' commercial paper.

Other guidance needed is how the decision to purchase commercial paper contrary to the recommendation in the credit analysis report should be documented. One instance was noted where a credit analysis report recommended against purchasing commercial paper of a corporation. However, the department frequently acquired commercial paper of this corporation contrary to that recommendation without documenting why such a decision was made.

If the period of time for which credit analysis reports are to be valid, when they are to be updated, and how decisions not to follow their recommendations are to be documented are not clearly established, the risk of purchasing commercial paper of a vulnerable corporation is increased.

Recommendation

The Treasurer should ensure that the department develops written procedures for the preparation and use of credit analysis reports that support the purchase of commercial paper. The procedures should indicate the period for which the reports should be valid, when they should be updated, and how decisions not to follow their recommendations should be documented.

Management's Comment

Management concurs. Procedures have been written relative to the process for the preparation and use of credit analysis reports. Regarding the credit analysis report referred to in this finding where the analyst requested a second opinion prior to approval, the chief investment officer reviewed and discussed the credit analysis report with the manager of cash management. The chief investment officer, who has final authority for investment decisions, authorized the acquisition of such commercial paper. While we concur that such decisions need to be documented, we would emphasize that the purchase of this commercial paper was properly authorized, and the state was not placed at risk by purchasing commercial paper issued by the company in question.

- 2. The Collateral Pool Board and the Department of the Treasury should ensure that annual, quarterly, and monthly reports required from participating financial institutions are received and reviewed**

Finding

The Collateral Pool was established in 1990 to allow financial institutions and governments statewide to participate in a collateral pool to provide an effective, low-risk system of collateralizing public funds. *Tennessee Code Annotated* prescribed the formation of the board to oversee the operations of the pool and attached the board, for administrative purposes, to the Department of the Treasury. The department began administering the pool in November 1995. Currently, the pool has approximately 47 participating financial institutions.

The Collateral Pool requires certain annual, quarterly, and monthly reports from participating financial institutions. These reports are used to determine if the institutions have reported all public deposits held and pledged sufficient collateral for the public deposits held. However, some required reports are not being received, are not received by the due date, or are not properly completed. Each type of report and related exceptions are discussed in the following paragraphs.

Pursuant to Rule 1700-4-1-.07(3) adopted by the Collateral Pool Board, every qualified public depository shall file an annual report not later than March 31 of each year. The annual report consists of two reports, the Annual Management Certification and the Annual Certification by Independent Auditors. The Annual Management Certification requires management to certify that their financial institution has the systems and controls in place to ensure that public deposits are properly identified and reported. The Annual Certification by Independent Auditors requires an independent auditor to certify that he/she has examined and tested the institution's systems and procedures that identify and report public deposits and found them effective, with any deficiencies noted in the audit report. The following exceptions were noted regarding the annual reporting requirements:

- Three of thirty-one institutions tested (10%) failed to submit complete annual reports. One bank failed to submit the Annual Certification by Independent Auditors. Two banks failed to submit the first page of the Annual Management Certification.
- Four of thirty-one institutions tested (13%) failed to submit the complete annual report or part of the annual report by the due date. The reports were submitted 47 to 179 days late, or an average of 125 days late.
- Three of thirty-one institutions tested (10%) failed to properly complete the Annual Certification by Independent Auditors. Two banks submitted an Annual Certification by Independent Auditors that was signed by the same person that signed the Annual Management Certification. The Annual Certification by Independent Auditors for the other bank stated that “There are no independent audits of these systems and procedures.”

Pursuant to Rule 1700-4-1-.07(2) adopted by the Collateral Pool Board, every qualified public depository shall file with the Treasurer on a quarterly basis a statement of selected financial information. The department has established a due date of 30 days after the end of each quarter. The following exceptions were noted regarding the quarterly reporting requirements:

- Four of thirty-one institutions tested (13%) failed to submit all required quarterly reports for the period tested. Three banks failed to submit one quarterly report. One bank failed to submit two quarterly reports.
- Six of thirty-one institutions tested (19%) failed to submit the quarterly report by the due date for the period tested. The reports were submitted 10 to 193 days late, or an average of 50 days late.

Pursuant to Section 9-4-518(a), *Tennessee Code Annotated*, and Rule 1700-4-1-.07(1) adopted by the Collateral Pool Board, a qualified public depository shall submit a monthly report to the Treasurer containing information required by the Board and prescribed by the Treasurer. The report includes a Monthly Depository Report and a Monthly Pledged Collateral Report. Both reports are due by the fifteenth (15th) day after the end of each calendar month. The following exceptions were noted regarding the monthly reporting requirements:

- Fourteen of thirty-one institutions tested (45%) failed to submit complete Monthly Pledged Collateral Reports for the months tested.
- Four of thirty-one institutions tested (13%) failed to submit the monthly report by the due date for the month tested. The reports were submitted 1 to 25 days late, or an average of 11 days late.

Although the department has attempted to follow up with institutions that fail to send required reports, it appears that the department lacks adequate enforcement procedures to ensure that required reports are completed and submitted to the department. Also, the department needs to review the Annual Management Certifications and the Annual Certifications by Independent Auditors to determine

that the appropriate person completes them. These reports are necessary to determine if all public deposits are sufficiently collateralized. The Annual Certification by Independent Auditors provides additional assurance from an independent auditor that the institution's systems and procedures are effective for identifying and reporting public deposits. This assurance is necessary in determining if adequate collateral has been pledged by each institution. If a participating financial institution becomes insolvent, the other Collateral Pool members are assessed for any collateral deficiency of the insolvent member. As a result, the risk of loss to a Collateral Pool member is increased if other pool members have not pledged collateral at the required target level.

Recommendation

The Collateral Pool Board should adopt enforcement procedures to help ensure that all required reports are submitted to the department by the due date and are properly completed. The enforcement procedures should be sufficiently strong to encourage compliance with reporting requirements. The department should review annual reports to ensure that an independent auditor has completed the Annual Certification by Independent Auditors and follow up with institutions that failed to have the certification properly completed by an independent auditor.

Management's Comment

Management concurs. In August 2001, Treasury Internal Audit identified the failure of collateral pool participants to timely file monthly, quarterly, and annual reports. The internal audit report stated "while cash management has followed-up with banks failing to submit the required reports through phone calls and letters, staff lacks the adequate enforcement procedures to ensure institutions are complying with the reporting requirements."

At the September 20, 2001, meeting of the Collateral Pool Board, the internal audit report was presented for the Board's consideration. The Board took three actions:

- a. The Board requested the Chairman to write the institutions that had not complied with filing the annual report. Subsequently, the reports were received.
- b. The Board eliminated the filing of the quarterly financial report by institutions and instead authorized the obtaining of financial data from a third party source.
- c. The Board requested staff to outline a series of recommendations for better enforcement to be considered at the next meeting, probably in March 2002.

In addition, the staff has implemented a tracking compliance log so that failure to timely file reports can be documented so as to address problems with specific institutions.

It should be noted that failure to report timely does not put public deposits at risk, since the risk of default is borne by financial institutions participating in the pool.