Department of the Treasury

For the Year Ended
June 30, 2003

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
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John G. Morgan
Comptroller

December 30, 2003

Members of the General Assembly
and
The Honorable Dale Sims, 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, 2003.

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

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/cj
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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, 2003

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, and the State Pooled Investment Fund; to determine compliance with certain provisions of laws, regulations, contracts, and grants; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDING

The Department of the Treasury's Reconciliation of Collateral Was Inadequate
Our review of the June 30, 2003, collateral reconciliation revealed significant differences between the department's listing of collateral and the third-party custodians' listings of collateral. These differences were not discovered during the department's reconciliations. One of the differences was due to a duplicate collateral security on the department's listing resulting in the state's deposits being undercollateralized by $1,852,926 at June 30, 2003 (page 9).

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, which contains all findings, recommendations, and management comments, please contact

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Audit Report
Department of the Treasury
For the Year Ended June 30, 2003

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Department of the Treasury
For the Year Ended June 30, 2003

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 State Pooled Investment Fund (including 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 11 major sections: Staff Services, Investments, Baccalaureate Education System Trust (BEST), Information Systems, Records Management, State Trust and Lock Box, 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, administrative services, 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. The **Records Management** section provides physical facilities management, forms control and copying, and safekeeeping. **State Trust and Lock Box** is responsible for remittance receiving and the operation of the Federal Reserve wire transfer facility used to send, receive, and transfer funds for the State 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, and the Baccalaureate Education System Trust. The section is also responsible for reconciling approximately 80 open 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

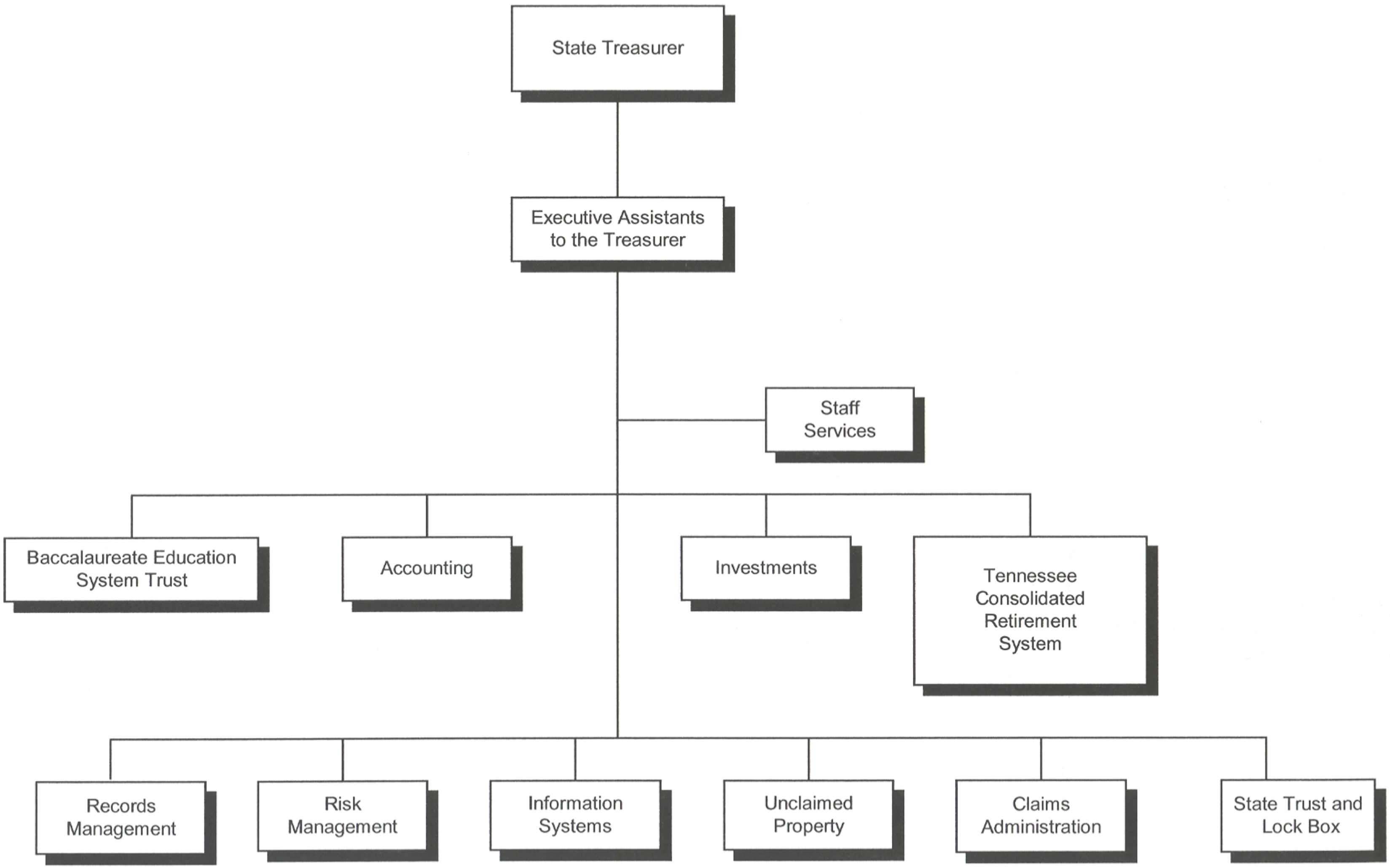
The audit was limited to the period July 1, 2002, through June 30, 2003, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

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 permanent fund; the Baccalaureate Education System Trust-Educational Services Plan, a private-purpose trust fund; the Flexible Benefits Plan, an employee benefit trust fund; and the State Pooled Investment Fund, an external investment pool (which includes the Local Government Investment Pool).

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
Certified Public Administrators	309.02
Criminal Injuries Compensation	313.03
Claims Award Fund	313.10
Risk Management	313.06
Unclaimed Property	313.20

DEPARTMENT OF THE TREASURY
ORGANIZATION CHART



OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. 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 Baccalaureate Education System Trust-Educational Services Plan, the Flexible Benefits Plan, and the State Pooled Investment Fund;

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

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of the Treasury filed its report with the Department of Audit on June 17, 2003. A follow-up of all prior audit findings was conducted as part of the current audit.

The current audit disclosed that the department has corrected the previous audit findings concerning the Wire Room Manager's access to the Federal Reserve's Fedline terminals not being adequately controlled; overpayments to Criminal Injury Compensation Program claimants; ensuring that annual reports required from participating financial institutions are received in a timely manner; and earnings of the Baccalaureate Education System Trust, Educational Services Plan being reduced because the department acted before a contract was obtained.

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 9, 2003.

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, and the State Pooled Investment Fund for the year ended June 30, 2003, 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 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. A reportable condition, along with the recommendation and management's response, is detailed in the Finding and Recommendation section of this report. 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, 2003

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, and the State Pooled Investment Fund as of and for the year ended June 30, 2003, and have issued our reports thereon dated December 4, 2003. 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. 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 a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. 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 condition was noted: The Department of the Treasury's reconciliation of collateral was inadequate. This condition is described in the Finding and Recommendation 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 do not believe that the reportable condition 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.

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,

Arthur A. Hayes, Jr., CPA,
Director

AAH/cj

FINDING AND RECOMMENDATION

The Department of the Treasury's reconciliation of collateral was inadequate

Finding

The Department of the Treasury is responsible for monitoring collateral for state deposits held in authorized state depository institutions, including public deposits held in Collateral Pool institutions. Accordingly, the department has developed a monitoring system and implemented related policies and procedures. As part of the monitoring process, the department maintains a listing of the collateral held by third-party custodians securing public deposits. The department compares this collateral to the amount of public deposits to ensure that the deposits have been adequately collateralized. The procedures also include a monthly reconciliation of the department's listing of collateral with the collateral held by third-party custodians. However, our review of the monthly reconciliation process indicated that the reconciliation was not adequately performed.

Our review of the June 30, 2003, collateral reconciliation revealed significant differences between the department's listing of collateral and the third-party custodians' listings of collateral. These differences were not discovered during the department's reconciliations. Specifically, our review indicated the following exceptions to the department's listing of collateral:

- Collateral securities totaling $99,565,000 did not appear on the third-party custodian's collateral listing because the trustee custodian had released 20 collateral securities without the department's approval. This did not cause an uncollateralized position at June 30, 2003. Based on discussion and correspondence with the custodian, $69,500,000 of the collateral was released by the custodian on May 21, 2003. The remaining difference, $30,065,000, was released prior to March 2003, according to the third-party custodian.

- A collateral security of $9,861,978 held by the trustee custodian was not recorded. This did not result in an uncollateralized position since the security was pledged in excess of the required collateral.

- There were three duplicate entries of collateral securities totaling $3,544,435. One of the duplicate entries resulted in the state's deposits being undercollateralized by $1,852,926 at June 30, 2003.

- A collateral security of $85,980 was recorded in an incorrect custodian account. This did not cause an uncollateralized position.

- The par value of a collateral security was recorded $200,000 lower than the value indicated by the third-party custodian. This did not result in an uncollateralized position since the security was pledged in excess of the required collateral.

The monthly reconciliations should have revealed these exceptions.

Management was asked about the department's procedures for dealing with custodians who release collateral in violation of their agreement. Management indicated that it is the department's policy to follow up with custodians who are found to have recurring problems with unauthorized release of collateral. They are reminded not to release collateral without the department's permission. Management further stated that continued violations would result in cancellation of the custodial agreement as permitted by the contract.

If the collateral reconciliations are not properly performed, there is the risk that depository institutions will not have pledged adequate collateral. This could result in a loss to the state in the event of a failed depository institution. There is also the risk that required disclosures would not be made in the notes to the financial statements regarding uncollateralized amounts.

Recommendation

The Cash Management Accountant should completely reconcile the department's listing of collateral with the third-party custodians' listings. Any differences should be documented and appropriately resolved. The Cash Manager should monitor the procedures to ensure the reconciliations are properly performed.

Management's Comment

Management concurs. With over 140 banks pledging more than 2,300 different securities as collateral at 11 trustee custodians, management recognized the need to automate the reconciliation of collateral with the trustee custodian given that collateral pledging, substitution, and releasing is a dynamic process involving more than 4,300 transactions each year.

More than a year ago management initiated a conversion to an automated reconciliation process by requiring the trustee custodians with the largest volume to begin electronically reporting collateral holdings. Management also requested QED, the department's software provider, to develop a program to perform an automated reconciliation between Treasury's records and the trustee custodians'. The software provider installed the new program in December 2003.

The automated reconciliation process will match the alpha-numeric cusip number (universal security identification), the maturity date, the coupon rate, and the par share amount between Treasury's records and the trustee custodians' records and generate a report of exceptions. Automation will allow more effort to resolve exceptions. This will be a superior method of performing the reconciliation than the current method of manually matching one set of records against another.