AUDIT REPORT

Department of State

October 2005

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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John G. Morgan
Comptroller

October 25, 2005

Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Riley C. Darnell
Secretary of State
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of State for the period July 1, 2001, through January 31, 2005.

The review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements resulted in a finding which is detailed in the Objectives, Methodologies, and Conclusions section of this report.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/th
05/039

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February 18, 2005

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

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Department of State for the period July 1, 2001, through January 31, 2005.

We conducted our audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we obtain an understanding of internal control significant to the audit objectives and that we design the audit to provide reasonable assurance of the Department of State's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Department of State is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

Our audit disclosed a finding which is detailed in the Objectives, Methodologies, and Conclusions section of this report. The department's administration has responded to the audit finding; we have included the response following the finding. We will follow up the audit to examine the application of the procedures instituted because of the audit finding.

We have reported other less significant matters involving the department's internal control and/or instances of noncompliance to the Department of State's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/th

State of Tennessee

Audit Highlights

Comptroller of the Treasury Division of State Audit

Financial and Compliance Audit
Department of State
October 2005

AUDIT SCOPE

We have audited the Department of State for the period July 1, 2001, through January 31, 2005. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of revenue; expenditures; equipment; the Division of Charitable Solicitations – gaming events; the Division of Business Services – Uniform Commercial Code, notary commissions, and summons; and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.

AUDIT FINDING

Cash-Receipting Function Not Adequate*

No controls are in place within the Corporate Management System (CMS) to prevent data-entry clerks from tying a new document received to a previously recorded document that had an equivalent charge and corresponding payment already posted to an account. The CMS simultaneously documents services provided by the department and receipts the fees collected. Therefore, documents could be filed and recorded, even though the proper fee had not been received for the new document (page 5).

* This finding is repeated from prior audits.

Financial and Compliance Audit
Department of State

TABLE OF CONTENTS

	Page
INTRODUCTION	1
Post-Audit Authority	1
Background	1
AUDIT SCOPE	4
PRIOR AUDIT FINDING	4
OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS	4
Revenue	4
Finding - The cash-receipting function of the Corporate Management System is not adequate	5
Expenditures	6
Equipment	7
Division of Charitable Solicitations–Gaming Events	8
Division of Business Services	8
Uniform Commercial Code	8
Notary Commissions and Summons	9
Financial Integrity Act	10
OBSERVATIONS AND COMMENTS	11
Fraud Considerations	11
Title VI of the Civil Rights Act of 1964	11
APPENDIX	12
Allotment Codes	12

Financial and Compliance Audit
Department of State

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of State. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which requires 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 Secretary of State is one of three constitutional officers provided by Tennessee's constitution. The Secretary of State, according to the constitution, is to maintain a register of the official acts and proceedings of the Governor and is to be prepared to present them before the General Assembly. Additional functions of the Secretary of State are outlined in the state statutes and regulations.

The Secretary of State is the chief officer of the Department of State. The Department of State keeps the original copies of all acts and resolutions adopted by the General Assembly and signed by the Governor. Certified copies of public and private acts are available for a nominal fee. The department is also required by statute to keep other records: the receipt and recording of corporate charters, the receipt of trademarks, the execution of notary commissions, and the receipt of state administrative regulations.

The Department of State is organized into nine major divisions: Fiscal and Administrative Services, Personnel and Development, Information Systems, Administrative Procedures, Business Services, Charitable Solicitations, Elections, Library and Archives, and Publications.

The Fiscal and Administrative Services division provides the general administrative services necessary to support the department. These include budgeting, accounting, procurement, and special administrative services.

The Personnel and Development division is responsible for the department's human resources activities. These activities include the management of employment practices, administration of employee programs, and compliance with human rights legislation.

The Information Systems division is responsible for all information technology services necessary to support the Department of State. These responsibilities include information systems and technology planning, project development and implementation, technical support, network planning and administration, and procurement assistance.

The Administrative Procedures division provides administrative judges to conduct contested case hearings for state administrative agencies and develops uniform rules of procedure for the conduct of those hearings. This division is also required to assist state agencies in complying with the Uniform Administrative Procedures Act.

The Business Services division executes the processing and recordkeeping duties of the Secretary of State relating to the following areas: Apostilles and Authentications, Corporations, Limited Liability Companies, Limited Liability Partnerships, Limited Partnerships, Mine Foreman Certificates, Motor Vehicle Temporary Liens, Municipal Clerk Certifications, Nonresident Fiduciary Appointments, Notary Commissions, Summons, State Deeds and Leases, Trademarks, and Uniform Commercial Code.

The Charitable Solicitations division is responsible for the registration and regulation of charitable organizations, charitable gaming events, professional solicitors, professional fund-raising counsels, and vendors that solicit contributions for the benefit of charitable organizations. The division also investigates fund-raising irregularities and takes appropriate action to assure public confidence in charitable activities.

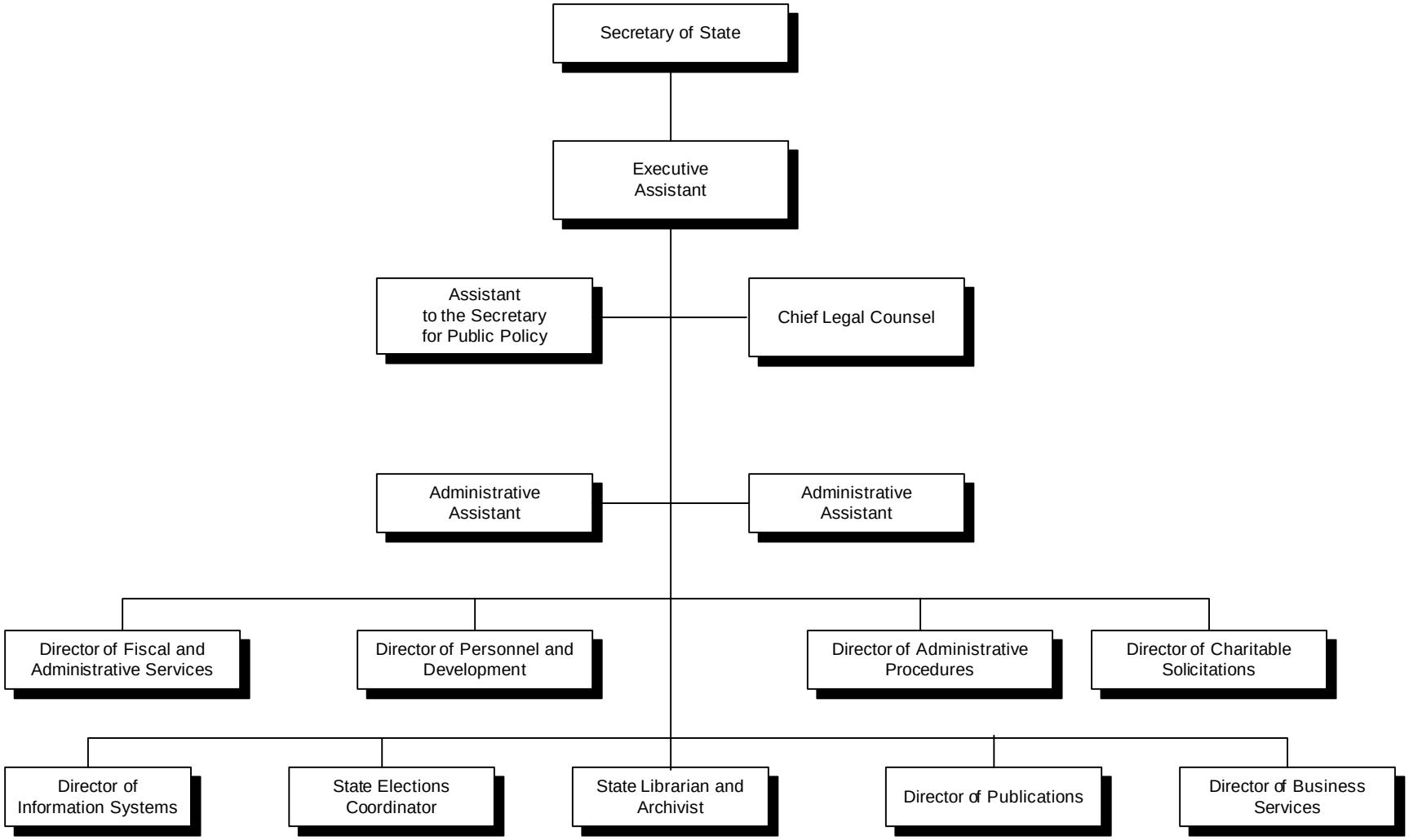
The Elections division is responsible for coordinating the activities of county election commissions and the uniformity of election procedures throughout the state. The coordinator interprets questions of the law for the benefit of all election officials, reviews election law legislation, and prepares the election manual and election handbooks for use by election officials.

The Library and Archives division collects and preserves books and records of historical, documentary, and reference value and encourages and promotes library development throughout the state.

The Publications division publishes the *Tennessee Blue Book*, *Public and Private Acts of the General Assembly*, *Tennessee Administrative Register*, *Tennessee Open Appointments Vacancy Report*, *Rules and Regulations of the State of Tennessee*, and other documents for which the Secretary of State is responsible. This division is also responsible for the creation and maintenance of the department's website.

An organization chart of the Department of State is on the following page.

Department of State
Organization Chart



AUDIT SCOPE

We have audited the Department of State for the period July 1, 2001, through January 31, 2005. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreements in the areas of revenue, expenditures, equipment, gaming events, Uniform Commercial Code, notary commissions and summons, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.

PRIOR AUDIT FINDING

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 State filed its report with the Department of Audit on June 28, 2002. A follow-up of the prior audit finding was conducted as part of the current audit.

The prior audit report contained a finding concerning inadequate cash-receipting procedures for the Corporate Management System. This finding has not been resolved and is repeated in the applicable section of this report.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

REVENUE

The objectives of our review of the revenue controls and procedures were to determine whether

- revenue transactions were properly recorded;
- cash collected during the audit period was deposited timely;

- revenue functions were adequately segregated and physical controls over cash were adequate;
- fees were charged and recorded at the correct amount;
- petty cash funds were authorized by the Department of Finance and Administration; and
- lists of new corporations and surrendered charters were furnished to the Department of Revenue.

We interviewed key department personnel to gain an understanding of the department's procedures and controls over revenue. We also reviewed supporting documentation for these procedures and controls. Testwork was performed on a nonstatistical sample of revenue transactions for adequate support, timely deposits, agreement of amounts receipted and deposited, correct recording, and proper approval. Petty cash accounts were counted and agreed to Department of Finance and Administration authorizations. The Department of Revenue was contacted to determine whether corporate listings were promptly received.

We determined that revenue transactions were properly recorded, cash was deposited timely, revenue functions were adequately segregated, physical controls over cash were adequate, fees were charged and recorded at the correct amount, petty cash funds were authorized, and the Department of Revenue promptly receives corporate listings. However, we determined that the cash-receipting function of the Corporate Management System is not adequate, as discussed in the following finding.

The cash-receipting function of the Corporate Management System is not adequate

Finding

As noted in the prior seven audits, improvements are needed in the cash-receipting procedures of the Corporate Management System (CMS), a computerized system that provides information on corporate filings of documents and other service fees. The system was implemented to simultaneously document services and receipt the fees collected. Corporate fees constitute the majority of the fees that are still processed through the CMS system; noncorporate fees are no longer processed through CMS as of November 1, 2004. As noted in prior audits, no controls are in place within CMS to prevent data-entry clerks from tying a new document received to a previously recorded document that had an equivalent charge and corresponding payment already posted to an account. Therefore, documents could be filed and recorded, even though the proper fee had not been received for the new document. Such a condition, known as lapping, is frequently associated with fraud. Failure to correct the cash-receipting problem could result in a loss of revenue for the department.

The department does have compensating controls to help reduce the risk of fraud. As the mail is opened, all checks are restrictively endorsed and scanned along with the corresponding document. The endorsement is to the Treasurer State of Tennessee, Department of State, and

also includes the bank account number. No cash is received by the data-entry clerks. When the document is approved, an acknowledgement of document approval letter is sent to the filing company. This letter also includes a receipt showing the name and address of the original company that the document was tied to.

Management concurred with the prior finding and stated that it was installing a new system. A new computerized system was tested but failed to meet the needs of the department. Management is still attempting to find the best solution to replace the existing CMS system.

Recommendation

Management should continue to pursue the installation of a new system that will ensure documents cannot be filed unless the fee remitted by the customer relates directly to the new documents submitted for filing.

Management's Comment

We concur. Multiple attempts to replace the Corporate Management System (CMS) have been made. The first attempt was with an outside vendor utilizing a Commercial Off-The-Shelf (COTS) software package. The second attempt was for a custom designed system to be produced by the Office for Information Resources (OIR). Unfortunately, neither attempt was successful.

In the meantime, another mission critical system in the Business Services Division, the Uniform Commercial Code Management System (UCCMS), reached the end of its useful life. By necessity, all resources were dedicated to upgrading the UCCMS. We are now in the final phase (Phase III) of the UCCMS full system upgrade that is due to be completed in November 2005. Once the system is fully upgraded and stable, we will then, once again, attempt to replace the existing Corporate Management System.

EXPENDITURES

The objectives of our review of the expenditure controls and procedures were to determine whether

- expenditures for goods or services were properly authorized, adequately supported, and correctly recorded in the state's accounting system;
- goods and services were received and procured in accordance with applicable regulations or requirements;
- sole-source contracts were valid;
- large expenditures classified as "other" or "maintenance and repairs" were appropriate;

- payments were made in a timely manner;
- payments for travel were made in accordance with the State of Tennessee Comprehensive Travel Regulations;
- contract payments complied with contract terms; and
- records were reconciled with Department of Finance and Administration reports.

We interviewed key departmental personnel to gain an understanding of the department's procedures and controls over expenditures. We reviewed supporting documentation and tested a nonstatistical sample of expenditures to ensure that transactions were adequately supported and approved and complied with state and department regulations and requirements. In addition, sole-source contracts were reviewed for validity. Also, large expenditures classified as "other" or "maintenance and repairs" were reviewed for propriety.

We determined that expenditures were properly authorized, adequately supported, and correctly recorded; goods and services were received and procured in accordance with applicable regulations or requirements; sole-source contracts were valid; large expenditures classified as "other" or "maintenance and repairs" were appropriate; payments were made timely; travel payments were made in accordance with the State of Tennessee Comprehensive Travel Regulations; contract payments complied with contract terms; and records were reconciled with Department of Finance and Administration reports.

EQUIPMENT

The objectives of our review of the equipment controls and procedures were to determine whether

- the information on the department's equipment listed in the Property of the State of Tennessee (POST) system is accurate and complete;
- equipment purchased during the audit period was properly recorded in POST;
- vehicles leased from Motor Vehicle Management could be located, the logbooks were up-to-date, and the logbook entries were appropriate;
- access to POST was properly restricted;
- proper procedures were followed for lost or stolen equipment; and
- property and equipment are adequately safeguarded.

We interviewed key department personnel to gain an understanding of the department's procedures and controls over equipment. We reviewed supporting documentation and tested a nonstatistical sample of equipment from the POST system. Equipment items were physically located, and tag number, serial number, and location were agreed to POST. For the equipment items tested that were purchased during the audit period, the cost recorded in POST was traced

to supporting documentation. We obtained from Motor Vehicle Management a listing of all vehicles being leased by the department and tested a nonstatistical sample to determine if the vehicles could be located, if logbooks were up-to-date, and if the logbook entries appeared appropriate. We also obtained a current listing of persons with access to POST. We then determined whether persons with access were active employees, had job duties which required this level of access, and had a level of access which created an adequate segregation of duties. A review of procedures was performed for lost or stolen equipment.

We determined that the information on the department's equipment listed in POST was accurate and complete and that equipment purchased during the audit period was properly recorded in POST with minor exceptions. We found that the leased vehicles could be located, the logbooks were up-to-date, and the logbook entries appeared appropriate. Employee access to POST was also appropriate. In addition, we determined that proper procedures had been followed for lost or stolen equipment and that property and equipment were adequately safeguarded.

DIVISION OF CHARITABLE SOLICITATIONS – GAMING EVENTS

The objectives of our review of the controls and procedures for the Division of Charitable Solicitations – Gaming Events were to determine whether

- annual event applications contained the proper information and documentation;
- a list of qualifying applicants was timely submitted to the clerks of the senate and the house and contained the required information; and
- fees had been charged and recorded at the correct amount.

We interviewed key department personnel to gain an understanding of the department's procedures and controls over gaming events. We reviewed supporting documentation and tested a nonstatistical sample of event applications. We obtained and reviewed the list of qualifying applicants to determine if it contained the required information and if it was submitted timely.

We determined that gaming event applications contained the proper information and documentation and that fees were charged and recorded at the correct amount. Also, the list of qualifying applicants was submitted timely and with the required information.

DIVISION OF BUSINESS SERVICES

Uniform Commercial Code

The objectives of our review of the controls and procedures over Uniform Commercial Code (UCC) filings in the Division of Business Services were to determine whether

- initial financing statements contained the proper information and documentation;
- the filing office properly numbered and maintained the filed records;
- fees had been charged and recorded at the correct amount;
- searchable database information agreed to information submitted on financing statement documentation; and
- the department reported to the Governor and general assembly on the operation of the filing office by the February 1 deadline.

We interviewed key department personnel to gain an understanding of the department's procedures and controls over UCC filings. We tested a nonstatistical sample of financing statements and reviewed supporting documentation to determine whether the financing statements submitted contained the proper information and documentation, the filing office properly numbered and maintained the filed records, and fees had been charged and recorded at the correct amount. The on-line database was searched to determine if the information reported agreed to the information submitted on the financing statement. We made inquiries regarding whether the department timely reported the operations of the filing office to the Governor and general assembly.

We determined that the financing statements contained the proper information and documentation, the filing office properly numbered and maintained the filed records, and fees were charged and recorded at the correct amount. The searchable on-line database information agreed with the information reported on the financing statement. The department reported the operation of the filing office by the February 1, 2005, deadline.

Notary Commissions and Summons

The objectives of our review of the controls and procedures for notary commissions and summons in the Division of Business Services were to determine whether

- policies and procedures for notary commissions and summons were adequate;
- selected transactions were in compliance with applicable *Tennessee Code Annotated* requirements and departmental policies and procedures; and
- fees had been charged and recorded at the correct amount.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's procedures and controls over notary commissions and summons. We reviewed supporting documentation and tested a nonstatistical sample of Business Services transactions for notary commissions and summons for compliance with applicable requirements and fees.

We determined that the policies and procedures for notary commissions and summons were adequate. The Business Services transactions tested for notary commissions and summons contained all information required by applicable *Tennessee Code Annotated* and departmental policies and procedures. Also, fees for the transactions were charged and recorded at the correct amount.

FINANCIAL INTEGRITY ACT

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the agency to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year. In addition, the head of each executive agency is required to conduct an evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

Our objectives were to determine whether

- the Department's June 30, 2004; June 30, 2003; and June 30, 2002, responsibility letters and December 31, 2003, internal accounting and administrative control report were filed in compliance with Section 9-18-104, *Tennessee Code Annotated;*
- documentation to support the department's evaluation of its internal accounting and administrative control was properly maintained;
- procedures used in compiling information for the internal accounting and administrative control report were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated;* and
- corrective actions are being implemented for weaknesses identified in the report.

We interviewed key employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the department's procedures. We also reviewed the June 30, 2004; June 30, 2003; and June 30, 2002, responsibility letters and the December 31, 2003, internal accounting and administrative control report to determine whether they had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration. To determine if corrective action plans had been implemented, we interviewed management and reviewed corrective action for the weaknesses identified in the report.

We determined that the Financial Integrity Act responsibility letters and internal accounting and administrative control report were submitted on time, support for the internal accounting and administrative control report was properly maintained, and procedures used were in compliance with *Tennessee Code Annotated.* Corrective actions are being taken on the weaknesses noted.

OBSERVATIONS AND COMMENTS

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, and not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

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 June 30 each year. The Department of State filed its compliance reports and implementation plans on June 26, 2002; June 27, 2003; and June 30, 2004.

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 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 Tennessee Title VI Compliance Commission is responsible for monitoring and enforcement of Title VI.

APPENDIX

ALLOTMENT CODES

305.01 Secretary of State
305.02 State Election Commission
305.03 Public Documents
305.04 State Library and Archives
305.05 Regional Library System
305.06 Library Construction
305.07 Registry of Election Finance
305.08 Economic Council on Women
305.09 Charitable Solicitations and Charitable Gaming
305.10 Help America Vote Act