AUDIT REPORT

Tennessee Regulatory Authority

February 2006

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
Department of Audit
Division of State Audit

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COMPTROLLER OF THE TREASURY
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John G. Morgan
Comptroller

February 14, 2006

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Ron Jones, Chairman
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Regulatory Authority for the period July 1, 2001, through February 24, 2005.

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

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/th
05/040

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COMPTROLLER OF THE TREASURY
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February 24, 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 Tennessee Regulatory Authority for the period July 1, 2001, through February 24, 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 Tennessee Regulatory Authority's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Tennessee Regulatory Authority 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 certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report. The Tennessee Regulatory Authority's administration has responded to the audit findings; we have included the responses following each finding. We will follow up the audit to examine the application of the procedures instituted because of the audit findings.

We have reported other less significant matters involving the authority's internal control and/or instances of noncompliance to the Tennessee Regulatory Authority's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/th

State of Tennessee

A u d i t   H i g h l i g h t s

Comptroller of the Treasury — Division of State Audit

Financial and Compliance Audit
Tennessee Regulatory Authority
February 2006

AUDIT SCOPE

We have audited the Tennessee Regulatory Authority for the period July 1, 2001, through February 24, 2005. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts and grant agreements in the areas of revenue, expenditures, equipment, payroll and personnel, conflicts of interest, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

INTERNAL CONTROL FINDINGS

Management Failed to Assess and Mitigate the Risk of Incompatible Duties by the Fiscal Officer
The fiscal officer has extensive access to all financial processes and procedures, which results in duties that are inadequately segregated (page 4).

TRA Management Did Not Always Adequately Monitor Expenditure Transactions to Ensure That the Proper Object Code Was Charged, Which Increases the Risk of an Undetected Fraud
Twelve of 25 expenditures tested were charged to the wrong object code (page 10).

Management Failed to Adequately Identify, Assess, and Address the Risks of Incomplete and Inaccurate Personnel Records

Time records were not always maintained or properly approved; personnel files did not always contain support for deductions from the employees' pay, the salary paid, or supplemental pay; one employee was placed on paid administrative leave pending disciplinary action related to a personnel issue for 72 calendar days without the approval of the Commissioner of the Department of Personnel; and FICA was not deducted and submitted to the Internal Revenue Service for one employee's pay during the audit period, nor was the employer's share submitted to the Internal Revenue Service (page 13).

The Necessary Notifications for Temporary Employees Receiving Retirement Benefits from the Tennessee Consolidated Retirement System (TCRS) Were Not Prepared and Sent, nor Were the Hours Worked Adequately Monitored by Management, Which Resulted in Excessive Hours Worked by One Temporary Employee During Two Separate Work Periods

The required temporary employment report for two of three temporary employees who were TCRS retirees was not completed and submitted to TCRS annually as required by state law. In addition, one of the temporary employees exceeded the statutorily established limit of 750 hours during both work periods audited, which could impact the amount of retirement benefits due to the employee (page 16).

COMPLIANCE FINDINGS

Title VI Reports Relating to Compliance With the Civil Rights Act of 1964 Were Not Submitted As Required

The June 30, 2003, Title VI compliance report and implementation plan was not submitted as required by Section 4-21-901, *Tennessee Code Annotated*, and the June 30, 2004, report was submitted 58 days after the due date (page 20).

Conflict-of-Interest Policy Needs Improvement

The authority's conflict-of-interest policy does not comply with state law regarding career service employees (page 18).

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INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Tennessee Regulatory Authority. 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 Tennessee Regulatory Authority is governed by four directors. One is appointed by the Governor, one by the Speaker of the Senate, one by the Speaker of the House of Representatives, and one by joint agreement among the Governor, the Speaker of the Senate, and the Speaker of the House of Representatives. Each director serves a six-year term. One director serves as the chairman of the authority. This position is rotated annually between the four commissioners. One of the duties of the chairman is to serve as the chief operating officer. The authority has jurisdiction over public utilities including electric companies, telephone companies, water companies, and natural gas companies. This jurisdiction includes approving all rates; auditing the utilities' compliance with applicable laws, orders, and policies of the authority; and inspecting natural gas pipelines. An organization chart of the authority is on the following page.

AUDIT SCOPE

We have audited the Tennessee Regulatory Authority for the period July 1, 2001, through February 24, 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, payroll and personnel, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller

General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; and providing support staff to various legislative committees and commissions.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

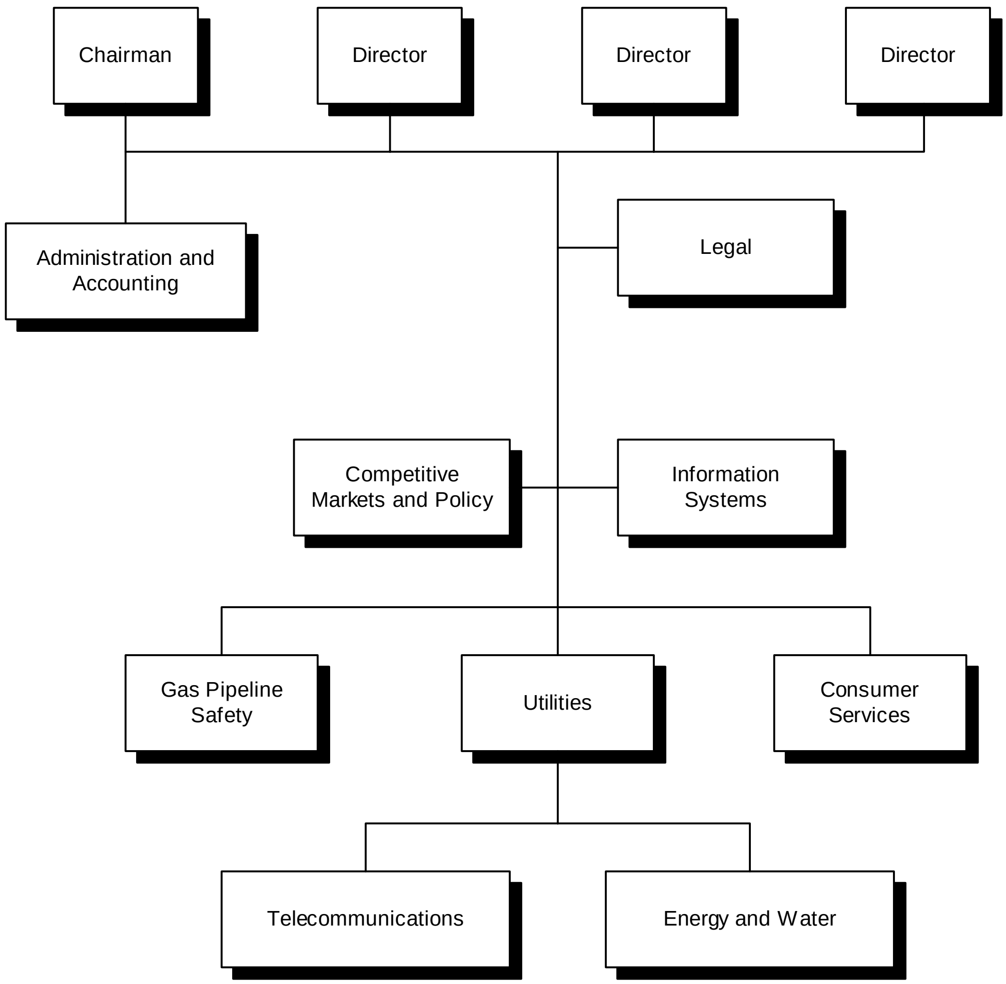
REVENUE

Our objectives for reviewing revenue controls and procedures were to determine whether

- controls over revenue were adequate;
- revenue transactions were properly supported, approved, recorded, and reconciled in the accounting system;
- revenue transactions were recorded accurately;
- cash and checks collected during the audit were deposited promptly and intact; and
- policies and procedures regarding fee collections and penalties for late fees were adequate.

We interviewed key authority personnel and reviewed supporting documentation to gain an understanding of the authority's controls over revenue and to determine procedures related to fee collections and penalties assessed for late fees. We selected a nonstatistical sample of revenue transactions from the State of Tennessee Accounting and Reporting System (STARS) for the period July 1, 2001, through September 30, 2004, to determine whether the revenue transactions were properly supported, approved, recorded, and accurate. Sample items were also tested to determine whether cash was deposited promptly and intact. We also discussed reconciliation procedures and reviewed a revenue reconciliation.

Tennessee Regulatory Authority
Organization Chart



Based on our interviews and reviews of supporting documentation, we determined that controls regarding revenue and fee collections procedures were adequate except for the segregation of duties (see finding 1). Based on our testwork, we determined that revenue transactions were properly supported, approved, recorded, and accurate, and cash was deposited promptly and intact. Based on our review of the reconciliation process, we determined that the revenue reconciliation and the related process were adequate.

1. <u>Management failed to assess and mitigate the risk of incompatible duties by the fiscal officer</u>

Finding

The fiscal officer has extensive access to all financial processes and procedures that occur within the authority, which results in duties that are inadequately segregated.

- The fiscal officer has sole responsibility for most aspects of tracking utility inspection fees. She tracks the receipt of utility inspection fees on a spreadsheet, identifies delinquent accounts, assesses and bills late fees, tracks payment of late fees on a spreadsheet, and reconciles receipt of late fees to assessment of late fees. Although another employee usually records the receipt of utility inspection fees and late fees in the State of Tennessee Accounting and Reporting System (STARS), the fiscal officer has the authority to record these payments in STARS. No independent review of this function is performed.
- The fiscal officer oversees the annual inventory process and reconciles annual inventory counts to the General Services property listing. No independent review of this reconciliation is performed.
- The fiscal officer approves all revenue transactions. She also has the authority to enter revenues into STARS and does so when the employee assigned this duty is away from the office.
- The fiscal officer receives, reviews, and approves most invoices for payment. She also has the authority to enter expenditures into STARS and does so when the employee assigned this duty is away from the office.
- The fiscal officer performs the duties of the procurement officer since no other employee is assigned these duties.
- The fiscal officer has the authority to prepare the payroll and supplemental pay, update personnel records, and approve supplemental pay. Although she doesn't perform these duties regularly, she performs them if the personnel officer is unavailable. A few instances were noted during testwork where the fiscal officer both prepared and approved supplemental pay. See part b of finding 3.

Adequately designed internal controls include a segregation of duties so that no one person has the authority to perform all aspects of a transaction. The inadequate segregation of duties has happened because of the limited number of employees in the fiscal office. While there have been no known errors or frauds associated with the lack of segregation of duties, the situation allows possible errors or fraud to occur and go undetected in a timely manner by management in the normal process of performing their duties and this key internal control weakness severely limits the ability of external auditors to detect errors or fraud through limited tests of transactions. In addition, the fiscal officer is the only employee who possesses a comprehensive understanding of the financial aspects of the authority. Should she leave or be unavailable for an extended period, the agency could have problems processing transactions in a timely manner.

Recommendation

The chairman and directors (who are top management) should take steps to adequately segregate the duties in the fiscal office even though the number of employees is limited or develop and implement adequate, working compensating controls. Duties could be better segregated by assigning qualified employees in various divisions to prepare or review reconciliations and to perform duties for fiscal personnel when they are not available. In addition, someone other than the fiscal officer should be assigned the procurement and property officer functions. Compensating controls could include requiring the chairman or his designee to regularly review screens and reports from STARS, the State Employees Information System (SEIS), or the Tennessee On-line Purchasing System (TOPS), to identify unusual transactions or transactions initiated, approved, and recorded by the same individual. Two examples are the TOPS screen “OABC” and the SEIS Payroll Input Transaction Register. A closer review could then be performed on those transactions to ensure their propriety. Any reviews should be documented by the person performing them. Any indications of errors, fraud, waste, or abuse should be immediately reported to the chairman and to the Division of State Audit. The chairman should periodically evaluate the job duties of the fiscal officer, especially when changes in circumstances or conditions occur, in order to ensure that duties are adequately segregated and to ensure that risks are adequately identified and assessed and that effective mitigating controls are designed and implemented. The risks and all mitigating controls should be adequately documented by the chairman and reviewed and approved by the directors.

Management’s Comment

We concur with the recommendation; however, we do not agree that management has failed to assess and mitigate the risk of incompatible duties by the fiscal officer. The TRA is funded for eighty-one (81) positions of which only three (3) are allocated to the fiscal office and are as follows: fiscal officer, accounting technician, and procurement officer. As detailed in the responses which follow to each of the six (6) subsections of this finding, the management of the TRA has implemented procedures and controls that the agency considers appropriate to mitigate the risk of the fiscal officer having incompatible duties.

Further, the most recent evaluation of internal accounting and administrative controls of the Tennessee Regulatory Authority performed in accordance with the requirements of the Tennessee Financial Integrity Act, as amended in 1998, did not result in any findings or weaknesses. As you are aware, the Financial Integrity Act is designed to insure that internal controls are in place to adequately safeguard assets and provide reasonable assurance of the proper recording of financial transactions, compliance with applicable laws and regulations, and the achievement of operational objectives. "The concept of reasonable assurance recognizes that the cost of internal control should not exceed the benefits expected to be derived." (SAS 1, AU 320.32)

Utility Inspection Fees:

The utility inspection fees collected by the TRA are based on the regulated companies' intrastate gross revenues which are reported to the TRA on a form provided to the approved regulated companies under the TRA's jurisdiction. The forms are generated by the TRA's Information Systems Division from information contained in the TRA's database which is established by the TRA's docket manager. The companies input their revenue information on the form, calculate the inspection fee, and return the form together with the applicable fee to the TRA. If the fee is sent to the TRA's lock box, the fee is received directly by the State's Treasury Department; if the fee is sent to the TRA's street address, the fee is received and recorded by the TRA's Administration Division before forwarding the payment to the State's Treasury Department. Upon receipt of the deposit slip from the Department of Treasury, the TRA's accounting technician records the receipt in STARS and the fiscal officer posts the payment to the Inspection Fee Database which was designed by the TRA's Information Services Division. The database automatically computes the inspection fee based on the intrastate revenues reported by the company. If the payment is not received by the due date, the database also calculates the applicable late fee. If the fee paid by the company is not correct, the database calculates the overpayment or underpayment.

An internal audit is completed annually of the intrastate revenues reported on the inspection fee form with the annual reports filed by the companies with the TRA's Utilities Division. The Agency implemented this internal audit which has been performed each year since the TRA was created. The variances between total fees collected based on the inspection fee forms and fees due based on the annual reports has been less than 1% in each audit year. In an effort to improve our practices to safeguard the TRA's assets, we will include as part of the Financial Integrity Act audit plan a component whereby the TRA's internal audit staff will review the audit of the intrastate revenues reported by the regulated companies to the TRA.

While the fiscal officer is responsible for ascertaining that all fees and applicable late fees are paid to the TRA according to state statute and the rules and regulations of the TRA, the TRA has reasonable assurance that sufficient controls are in place governing the calculation and payment of utility inspection fees consistent with our comments herein. We will, however, incorporate into the existing framework of our financial controls prudent improvements consistent with the findings expressed in this audit report.

Inventory:

The fiscal officer is responsible for the oversight of the annual inventory process and reconciliation. During the year, the TRA's Information Systems Division maintains a database of all computer equipment and peripherals which comprises the majority of the TRA's inventory. Upon receiving instructions from General Services to reconcile the inventory, the fiscal officer's first step is to have members of the TRA staff complete and sign an inventory form detailing those inventory items assigned to them. A spreadsheet is prepared by the fiscal officer detailing the inventory items as reported on the inventory forms submitted by staff.

All computer items and peripherals reported by staff are compared with the database maintained independently by the Information Systems Division and discrepancies are investigated and reconciled. Reconciliation with the inventory as shown by General Services is then performed. The TRA is of the opinion that two reconciliations with two independent sources provide reasonable assurance that an independent review exists of the inventory and reconciliation process. We will, however, incorporate into the existing framework of our financial controls prudent improvements consistent with the findings expressed in this audit report.

Revenue Transactions:

The fiscal officer approves all revenue transactions. Due to the limited number of fiscal office staff, the fiscal officer has also entered revenues into STARS when the accounting technician is on annual or sick leave. Upon the accounting technician's return from leave, the accounting technician reviews the revenue transactions entered into STARS during her absence while she is entering the information into an Excel spreadsheet by month which is later reconciled with the monthly STARS reports. Therefore, the Agency has reasonable assurance that sufficient controls are in place governing the recording of revenue. Further, subsequent to the completion of this audit, the TRA hired an individual who will be trained on entering revenue transactions in the absence of the accounting technician.

Invoice Payments:

Each purchase made by the TRA is initiated at the division level within the TRA by the submission of an Internal Action Request. Upon receipt of the related invoice, the invoice is matched with the Internal Action Request and receiving slip by the procurement officer. The invoice and related documentation is reviewed for accuracy and completeness, initialed by the fiscal officer, and posted by the fiscal officer to a spreadsheet for reconciliation with the monthly accounting reports received from F&A. The invoice is then processed by the accounting technician through the TOPS and/or STARS systems. The fiscal officer and the Chairman of the TRA independently review, approve, and sign the disbursement voucher register prior to it being submitted to F&A for payment. Although the fiscal officer can enter expenditures into STARS in the absence of the accounting technician, the TRA has reasonable assurance that adequate approval controls are in place to prevent any unauthorized payments.

Procurement:

Subsequent to the completion of this audit, the TRA hired an individual to fill the procurement officer position which has been vacant for a year. Again, since the fiscal officer does not initiate purchases and all purchases are reviewed and approved by the Chairman's office, the TRA concluded that its procedures provided reasonable assurance that the potential for fraudulent activity was mitigated during the time the fiscal officer was performing the procurement duties.

Payroll:

Due to turnover in the personnel officer position (four individuals in as many years) and the sensitivity of personnel issues, the TRA concluded that the Agency was best served by having the fiscal officer serve as backup for the personnel officer. Although the fiscal officer has the authority to prepare the payroll and supplemental pay, update personnel records, and approve supplemental pay, she only exercised this authority when extenuating circumstances were present. Since the state's Department of Personnel will only approve and process payroll transactions that are properly documented, the Agency has reasonable assurance that adequate approval controls are in place to prevent any unauthorized payments. To further strengthen the Agency's controls regarding personnel transactions, the TRA has filled a position with an individual whose responsibilities include performing the personnel duties in the absence of the personnel officer.

EXPENDITURES

Our objectives for reviewing expenditure controls and procedures were to determine whether

- controls over expenditures were adequate;
- access to the State of Tennessee On-Line Purchasing System (TOPS) and the State of Tennessee Accounting and Reporting System (STARS) was properly restricted;
- expenditure transactions were properly supported, approved, recorded, and reconciled in the accounting system;
- payments were made in a timely manner;
- expenditures complied with applicable state laws and regulations;
- expenditures for travel complied with the Comprehensive Travel Regulations;
- contracts were in accordance with regulations, and contract payments complied with contract terms and purchasing guidelines;
- cell phone and procurement card use was in agreement with the agency's policies and procedures, and the related expenditures were made and authorized;

- authority voucher registers were reconciled to Finance and Administration reports; and

- grants were set up and expensed in accordance with Policy 20.

We reviewed applicable laws and regulations, interviewed key authority personnel, and reviewed supporting documentation to gain an understanding of the authority's controls over expenditures and to determine whether grants were set up and expensed in accordance with Policy 20. We reviewed the TOPS and STARS security files to determine which employees were recognized users and to determine whether these employees' levels of access properly related to their job duties. A nonstatistical sample of expenditures for the period July 1, 2001, through September 30, 2004, was selected and tested to determine whether expenditure transactions were properly supported, approved, and recorded; payments were made in a timely manner; and expenditures complied with applicable laws and regulations. Sample items related to travel were tested for compliance with the Comprehensive Travel Regulations, and sample items related to contract payments were tested for compliance with contract terms and purchasing guidelines. We interviewed key authority personnel and reviewed selected cellular phone and procurement card bills to determine that only appropriate calls and charges were made and authorized. Reconciliation procedures were discussed with management. A reconciliation of voucher registers with the Department of Finance and Administration's STARS reports was reviewed to determine if any unusual reconciling items were identified.

Based on our interviews and reviews of supporting documentation, we determined that the authority's controls regarding expenditures were adequate except for the segregation of duties (see finding 1). Also, based on interviews and reviews, we determined that grants were set up and expensed in accordance with Policy 20. Based on our review of the TOPS and STARS security files, we determined that recognized users were employees and that these employees' levels of access appeared reasonable based on their job duties. The sample expenditure items were properly supported, approved, and recorded; payments were made in a timely manner; and expenditures complied with applicable laws and regulations. Sample items related to travel were made in compliance with the Comprehensive Travel Regulations, and sample items related to contract payments were made in compliance with contract terms and purchasing guidelines. Cellular phone bills and procurement card purchases included only appropriate calls and charges which were made and authorized. Based on discussions with management, expenditure reconciliation procedures appeared adequate. The review of a reconciliation of voucher registers with the Department of Finance and Administration's STARS reports appears adequate, and no unusual reconciling items were identified.

EQUIPMENT

Our objectives for reviewing equipment controls and procedures were to determine whether

- controls over equipment were adequate;

- access to the Property of the State of Tennessee (POST) system was properly restricted;
- equipment on the POST inventory listing could be physically located or confirmed,
- description, tag number, serial number, and locations in POST were correct;
- equipment and sensitive item expenditures were recorded properly in the State of Tennessee Accounting and Reporting System (STARS) and promptly added in POST;
- bills for property leased from the Department of Finance and Administration's Office for Information Resources (OIR) appeared proper; and
- proper procedures were followed for equipment that was lost or stolen.

We interviewed key authority personnel and reviewed supporting documentation to gain an understanding of the authority's controls over equipment including those related to lost or stolen equipment. We reviewed the POST security file to determine which employees were recognized users and to determine whether these employees' levels of access properly related to their job duties. We selected a nonstatistical sample of equipment items on POST at December 20, 2004, to determine whether equipment on the POST inventory listing could be physically located or confirmed and whether the description, tag number, serial number, and location in POST were correct. We selected a sample of items charged to the sensitive items object code for the period July 1, 2001, through September 30, 2004, to determine whether they were recorded properly in STARS and promptly in POST. OIR billings were reviewed for propriety.

Based on our interviews and reviews of supporting documentation, we determined that controls regarding equipment including those related to lost or stolen equipment appeared adequate except for the segregation of duties (see finding 1). Based on our review of the POST security file and users' job duties, recognized users were employees and their levels of access appeared reasonable based on their job duties. Based on our nonstatistical sample of equipment items on POST, equipment from the POST inventory listing was physically located or confirmed and the description, tag number, serial number, and location in POST were correct. Based on our sample of items charged to the sensitive items object code, items were promptly recorded in POST; however, they were not always recorded properly in STARS (see finding 2). Our review of OIR billings indicated no problems.

2. <u>TRA management did not always adequately monitor expenditure transactions to ensure that the proper object code was charged, which increases the risk of an undetected fraud</u>

Finding

Employees of the Tennessee Regulatory Authority did not always charge expenditures to the proper object code. Furthermore, the fiscal officer did not always adequately monitor expenditure transactions to ensure that the proper object code was charged. Testwork was performed on 25 expenditures that were charged to the sensitive minor equipment object code

(099). The object code listing as included in the *Department of General Services' Agency Purchasing Procedures Manual* defines sensitive minor equipment as "sensitive items such as calculators, tape recorders, weapons, etc., as determined by the State Personal Property Section" with a cost of less than $500. Twelve of the 25 expenditures tested (48%) were charged to the wrong object code. Of the 12 incorrectly charged expenditures, 7 were for the purchase of computer-related supplies that should have been charged to the data processing supplies object code (096), and 5 were for repairs and replacements that should have been charged to the maintenance of data processing equipment object code (074).

The purchasing officer duties are currently being performed by the fiscal director, which results in a problem with segregation of duties as mentioned in finding 1. Charging expenditures to the wrong object code could cause non-equipment items such as supplies to be included on the authority's equipment listing. In addition, charging expenditures to the wrong object code circumvents budgetary controls. The risk of an undetected fraud increases when expenditure transactions are inadequately monitored.

Recommendation

The fiscal officer should ensure that anyone who assumes the duties of the purchasing officer understands the rules related to purchasing, including how to determine the correct object code. The fiscal officer should monitor the work of the purchasing officer to ensure that he or she has an understanding of the purchasing rules, and the fiscal officer should provide the necessary training. The chairman should ensure that risks such as the one noted in this finding are adequately identified and assessed and that effective mitigating controls are designed and implemented. These controls should include ongoing monitoring for compliance with all pertinent requirements. The risks and all mitigating controls should be adequately documented by the chairman and reviewed and approved by the directors.

Management's Comment

We concur. Subsequent to the completion of this audit, the TRA hired an individual to fill the procurement officer position which has been vacant for a year. This individual has been thoroughly trained in the state's purchasing rules and the proper use of object codes. The fiscal officer will review each invoice for proper coding and adherence to the state's purchasing rules and regulations.

PAYROLL AND PERSONNEL

Our objectives for reviewing payroll and personnel controls and procedures were to determine whether

- controls over payroll and personnel were adequate;
- access to the State Employee Information System (SEIS) was properly restricted;
- gross pay agreed with personnel records, deductions were properly supported, salaries were charged to the proper cost center, time records were signed by the employee and approved by the supervisor, and leave was accrued and taken in accordance with applicable guidelines;
- newly hired employees or employees who changed positions during the audit period met the qualifications for the jobs held, civil service employees were hired from the appropriate list, the initial wage was within the salary range, and the amount paid was properly computed;
- final pay for employees terminated during the audit period was properly computed and the employee did not appear on the next succeeding payroll register;
- supplemental pay transactions were reasonable, supported, and properly approved; and
- the guidelines in Section 8-36-805, *Tennessee Code Annotated*, were followed for employees who were Tennessee Consolidated Retirement System (TCRS) retirees.

We interviewed key authority personnel and reviewed supporting documentation to gain an understanding of the authority's controls over payroll and personnel. We reviewed the SEIS security file to determine which employees were recognized users and to determine whether these employees' levels of access properly related to their job duties. We selected a sample of payroll transactions from July 1, 2001, through September 30, 2004, from SEIS to determine whether gross pay agreed with personnel records, deductions were properly supported, salaries were charged to the proper cost center, time records were signed by the employee and approved by the supervisor, and leave was accrued and taken in accordance with applicable guidelines. We also reviewed timesheets of administrative employees for approval of time and leave. Additionally, we reviewed the personnel files to determine whether newly hired employees or employees who changed positions during the audit period met the qualifications for the jobs held, civil service employees were hired from the appropriate list, the initial wage was within the salary range, and the amount paid was properly computed. For employees included in the sample who terminated employment, we reviewed the final pay calculation and the subsequent payroll register to determine whether final pay was properly computed and the employee appeared on the next succeeding payroll register. We reviewed supplemental pay for each employee who received more than $1,000 in supplemental pay from July 1, 2001, through September 30, 2004, to determine whether supplemental pay transactions were reasonable, supported, and properly approved.

Finally, we reviewed personnel files and contacted TCRS personnel to determine whether guidelines in Section 8-36-805, *Tennessee Code Annotated*, regarding employees who are TCRS retirees were followed by the authority.

Based on our interviews and reviews of supporting documentation, we determined that controls regarding payroll and personnel were adequate except for segregation of duties (see finding 1). Based on our review of the SEIS security file, we determined that recognized users were current employees and their levels of access appeared reasonable based on their job duties. Our sample of payroll transactions indicated that gross pay agreed with personnel records, deductions were properly supported, salaries were charged to the proper cost center, and leave was accrued and taken in accordance with applicable guidelines. Based on our sample testwork and our review of administrative time records, we determined that time records were not always signed by the employee and approved by the supervisor (see finding 3). Our review of the personnel files indicated newly hired employees or employees who changed positions during the audit period met the qualifications for the jobs held, civil service employees were hired from the appropriate list, the initial wage was within the salary range, and the amount paid was properly computed. Testwork indicated that the final pay for employees included in the sample who terminated employment during the audit period was properly computed, and the terminated employees did not appear on the next succeeding payroll register. However, we noted a situation where the proper approval was not obtained for an employee who was placed on administrative leave that exceeded 30 days (see finding 3). Our review of supplemental pay indicated supplemental pay transactions were reasonable; however, they were not always supported and properly approved (see finding 3). Finally, our review of personnel files and discussions with TCRS personnel indicated that the guidelines in Section 8-36-805, *Tennessee Code Annotated*, regarding TCRS retirees had not been followed (see finding 4).

3. **Management failed to adequately identify, assess, and address the risks of incomplete and inaccurate personnel records**

Finding

Personnel files and payroll records were not always complete and accurate, nor were controls in place to detect missing or inaccurate information. Several issues were identified, as described below.

a. Time records were not always maintained or properly approved. Our testwork revealed 5 of 25 payroll transactions (20%) that were not supported by properly executed timesheets. Two of the timesheets were missing, two were not signed by the supervisor, and one was not signed prior to the payroll date by the employee. We also reviewed all of the timesheets for the four fiscal and personnel division employees. Of the 308 timesheets reviewed, 35 (11%) were not signed by the supervisor. In addition to a timesheet, part-time employees complete a part-time employee time report, which is an internal document used by the authority to support the hours claimed on timesheets prepared by part-time employees. One of the four fiscal and personnel division employees previously mentioned was a part-time employee. The supervisor had not signed 64 of 85 part-time employee time reports prepared by this employee (75%). *Tennessee Department of Personnel Attendance and Leave Policies and Procedures*, Chapter 22, "Attendance and Leave Records and Reports," requires that "a hard copy attendance and leave record per pay period per employee must be submitted to the proper audit authority at the end of each pay period. This record must be signed by both the employee and his supervisor, verifying the correctness of the hours scheduled and worked and leave taken." Management has not developed and implemented controls to ensure that each timesheet and time report is approved by the supervisor and maintained as a permanent record for the transaction. Thus, the payroll officer did not always review the timesheets to ensure that the supervisors had documented their review of the employee timesheets. If time records are not reviewed, approved, and retained, management cannot be assured that employees are properly paid only the amounts they have earned and that leave balances are properly stated.

b. The personnel files did not always contain support for deductions from the employees' pay, the salary paid, or supplemental pay. Three of 25 personnel files tested (12%) did not include all required support. Two of the files did not include support for the employee's credit union deduction, and the other file did not include the state's personnel action form (PNF 201) to document the employee's salary. We also reviewed all supplemental payroll transactions for employees who received $1,000 or more in total supplemental pay during the audit period. Of the 48 transactions tested, properly approved requests for supplemental pay were not retained in the personnel files for 11 transactions (23%). Five of the requests were both prepared and approved solely by the fiscal officer; three of the requests had an approved amount that differed from the amount paid; three requests were missing; and one request had no approval. The three requests that were approved for an amount that differed from the amount paid resulted from using the wrong salary or the wrong time period for the calculation. These errors were detected and corrected prior to payment by employees in the Department of Personnel. The section related to personnel records in the *Tennessee Regulatory Authority Policies and Procedures Manual* states that "all employee personnel and medical insurance records are maintained in the TRA's Personnel Office. Your file contains a copy of . . . your salary history [PNF 201] . . . and any other pertinent information relating to your employment." The failure to maintain support to document payroll deductions could result in pay being inappropriately withheld from the employee's salary. Management has not performed adequate oversight to ensure the agency's policies are being followed. Also, good internal controls require that support for transactions be maintained; be prepared, reviewed, and approved by separate individuals; and be posted in agreement with the approved support. Employees could be fraudulently over or underpaid when transactions are posted without accurate support or approval. However, our review of timesheets and supplemental pay requests revealed no indications of fraud, and no overpayments or underpayments had to be recovered or paid.

c. One employee was placed on paid administrative leave pending disciplinary action related to a personnel issue for 72 calendar days without the approval of the Commissioner of the Department of Personnel. The *Tennessee Department of Personnel Leave and Attendance Policies and Procedures*, Chapter 3, "Administrative Leave–Discretionary Leave with Pay," requires approval by the Commissioner of the Department of Personnel when paid administrative leave exceeds 30 days. Thus, the employee received a paycheck for 42 days without proper authorization, and the authority did not comply with state policies. The employee's employment was terminated.

d. Federal Insurance Contributions Act (FICA) tax was not deducted and submitted to the Internal Revenue Service for one employee's pay during the audit period, nor was the employer's share submitted to the Internal Revenue Service. Title 26, *United States Code Annotated*, Section 3102, requires that FICA be deducted from each employee's payroll and submitted along with the employer's share to the Internal Revenue Service. The employee's retirement type was miscoded when the employee was hired in 2000. Since no FICA was paid or reported to the Internal Revenue Service, this employee's service credits are understated, which may affect the amount of Social Security benefits paid when the employee starts receiving Social Security benefits. The payroll officer notified the personnel section of the Department of Finance and Administration (F&A) when this exception was brought to her attention by us. She is working with F&A to ensure that the IRS and the employee are notified of this exception and that the proper taxes are paid. A review of all payroll transactions during the audit period revealed that this was the only instance where FICA was not deducted and submitted as required.

Recommendation

The chairman (who is part of top management) should ensure that controls related to payroll and personnel transactions are adequate and placed into operation. In particular, the chairman should ensure that timesheets are always maintained and properly approved, that personnel files contain support of deductions from the employees' pay, that policies regarding administrative leave are followed, and that controls are in place to detect coding errors. In addition, the payroll officer should continue to work with F&A to determine the amount of underpaid FICA tax and to ensure that the tax is paid. The chairman should ensure that risks such as the ones noted in this finding are adequately identified and assessed and that effective mitigating controls are designed and implemented. These controls should include ongoing monitoring for compliance with all pertinent requirements. The risks and all mitigating controls should be adequately documented by the chairman and reviewed and approved by the directors.

Management's Comment

We concur. The personnel officer hired on November 1, 2004, has reviewed every personnel file for completeness and accuracy and has taken steps to correct any deficiencies. Each file is now organized by type and date of transaction. Management is reasonably assured that most, if not all, of the weaknesses cited have been addressed and will not occur in the future.

Further, the personnel officer is working with the Payroll Division of F&A to ensure that the FICA tax that was not deducted from an employee is paid to the state by that employee.

4. The necessary notifications for temporary employees receiving retirement benefits from the Tennessee Consolidated Retirement System were not prepared and sent, nor were the hours worked adequately monitored by management, which resulted in excessive hours worked by one temporary employee during two separate work periods

Finding

The former personnel officer did not prepare and send the necessary notifications to the Tennessee Consolidated Retirement System (TCRS) for temporary employees receiving retirement benefits from TCRS, nor were the hours worked adequately monitored in order to prevent overpayment of retirement benefits. Section 8-36-805, *Tennessee Code Annotated*, allows retired TCRS members to temporarily return to state service provided certain conditions are met. These conditions include submitting an annual temporary employment form, which is called a Temporary Employment Report, to TCRS that indicates the employee's "name, period to be employed, number of days to be worked, compensation to be paid, and anticipated termination date," and not working more than 100 days or the equivalent thereof (750 hours) during a 12-month period. Legislation was passed and takes effect on July 1, 2005, that will increase the number of days allowed to 120.

The *Tennessee Consolidated Retirement System Employer Manual*, Section 626, provides the following guidance to employers for temporarily hiring TCRS retirees:

> When the retiree begins temporary employment, he and the employer must complete the temporary employment form and send it to the TCRS. The TCRS must be notified by letter when the retiree's temporary employment reaches the 100 day limit and/or when employment is terminated to avoid possible overpayment or suspension of the monthly benefit. A new form must be completed for each 12 month period.

During the audit period, the authority employed three temporary employees who were receiving retirement benefits from TCRS. The required temporary employment report was not completed and sent to TCRS for two of the employees. In addition, the number of hours worked by these temporary employees was not adequately monitored by the former personnel officer or the temporary employee, and TCRS was not notified when the 100-day limit was reached. As a result, one of the employees worked more than the maximum of 750 hours. As of May 31, 2003, an excess of 68 hours was worked, and as of May 31, 2002, an excess of 32 hours was worked. The excessive hours worked could impact the retirement benefits received by this employee, and the employee may have been overpaid.

The former personnel officer incorrectly thought that the retiree was solely responsible for notifying TCRS of any temporary return to service and the number of hours worked.

Recommendation

The personnel director should ensure that the temporary employment report and any other communications with TCRS are completed and submitted to TCRS in a timely manner. In addition, the personnel director should notify TCRS of the excessive hours worked by the employee noted in this finding, and should provide the necessary assistance for TCRS to recover any retirement benefit overpayments. The chairman (who is part of top management) should ensure that the personnel officer complies with Section 8-36-805, *Tennessee Code Annotated*, when temporarily hiring and employing TCRS retirees and reads, understands, and complies with all laws, policies, and manuals relevant to the job of personnel officer. The chairman should ensure that risks such as the one noted in this finding are adequately identified and assessed and that effective mitigating controls are designed and implemented. These controls should include ongoing monitoring for compliance with all pertinent requirements. The risks and all mitigating controls should be adequately documented by the chairman and reviewed and approved by the directors.

Management's Comment

We concur. The personnel officer has been trained in the documentation requirements of TCRS including the type of forms to be filed, the due dates for those forms, and the tracking of hours worked by those retired temporary employees.

CONFLICTS OF INTEREST

Our objective in reviewing the conflict-of-interest policies and procedures was to determine whether the policies and procedures were adequate and in compliance with state law.

We interviewed key authority personnel and reviewed supporting documentation to gain an understanding of the authority's policies and procedures regarding conflicts of interest.

Based on our review, we determined that the authority has a conflict-of-interest policy for its employees; however, this policy does not comply with state law (see finding 5).

5. <u>Conflict-of-interest policy needs improvement</u>

Finding

The authority's conflict-of-interest policy does not comply with state law regarding career service employees. Section 8-50-506, *Tennessee Code Annotated*, states that career service employees cannot be required to make financial disclosures unless a financial conflict of $5,000 or greater exists. In addition, state law requires that career service employees notify their supervisor of any potential conflicts with assignments, and they are to be informed of the disclosure requirements in writing "upon hiring and annually thereafter." The authority's policy requires that each employee, regardless of status, complete a conflict-of-interest statement disclosing any financial interest in a company regulated by the authority or that has a business relationship with the authority, and the statement must disclose any immediate family members who are employed by one of the companies regulated by the authority. The completion of a conflict-of-interest statement is required upon hiring and each January 1 thereafter.

Most of the authority's employees are career service employees; thus, they cannot be required to complete a conflict-of-interest statement unless they have a financial conflict of $5,000 or more. In addition, the authority does not have a process established regarding annual communications to career service employees of the legal requirements regarding conflicts of interest, nor does the authority's policy address these communications.

Recommendation

The chairman should update the authority's conflict-of-interest policy to exclude career service employees from the required disclosure of conflicts of interest and to include the annual communication to career service employees. In addition, he should develop a process to ensure that the written communications regarding conflicts of interest are prepared and delivered to all career service employees upon hiring and annually thereafter. Documentation of these communications should be maintained.

Management's Comment

We concur. The personnel officer is working with the Department of Personnel to ensure that the TRA is in compliance with the state's policy regarding conflict of interest statements and policy.

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 authority'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 authority'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 have been 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 authority'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 have been taken on the weaknesses noted.

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 Tennessee Regulatory Authority filed its compliance reports and implementation plans for June 30, 2004, and June 30, 2002, on August 28, 2004, and July 15, 2002, respectively. The June 30, 2003, report was not submitted (see finding 6).

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.

6. <u>Title VI reports relating to compliance with the Civil Rights Act of 1964 were not submitted as required</u>

Finding

The June 30, 2003, Title VI compliance report and implementation plan was not submitted as required by Section 4-21-901, *Tennessee Code Annotated*, and the June 30, 2004, report was submitted 58 days after the due date. Section 4-21-901 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.

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 absence or late submission of a Title VI compliance report and implementation plan could indicate that inadequate attention is being given to preventing discrimination based on a person's race, color, or national origin.

Recommendation

The chairman of the authority should ensure that the Title VI compliance report and implementation plan is prepared and submitted each June 30 in compliance with the *Tennessee Code Annotated*.

Management's Comment

We concur. Management has instructed the Title VI compliance officer to strictly adhere to the requirements and due dates of the Title VI reports. The June 30, 2003, report was mistakenly sent to the wrong agency and has since been filed with the Department of Audit. Management will ascertain each June 30th that all Title VI filing requirements have, in fact, been met.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the department. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the department is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the department.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the department. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the controls after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, "Consideration of Fraud in a Financial Statement Audit," 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. We have elected to apply the intent of SAS 99 to compliance audits in addition to financial statement audits.

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.

APPENDIX

ALLOTMENT CODE

The Tennessee Regulatory Authority has one division and allotment code: 316.11.