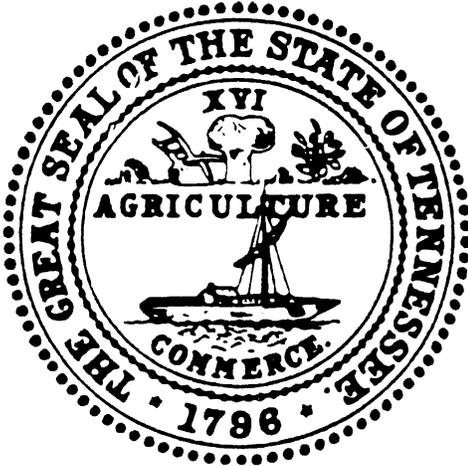


AUDIT REPORT

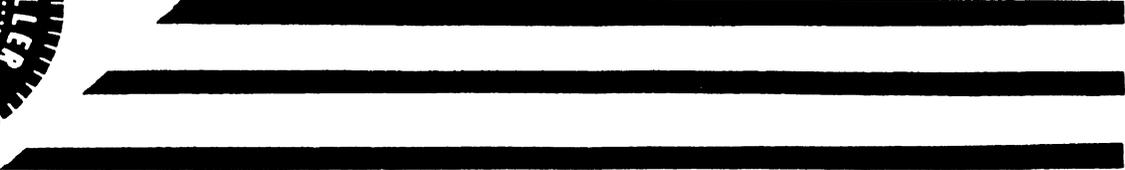
Health Services and Development Agency

July 2005



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

State Capitol
Nashville, Tennessee 37243-0260
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John G. Morgan
Comptroller

July 26, 2005

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243

and
Ms. Melanie Hill, Executive Director
Health Services and Development Agency
Suite 850, Andrew Jackson Building
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Health Services and Development Agency for the period July 1, 2001, through February 28, 2005.

The review of internal control and compliance with laws and regulations resulted in no audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/eb
05/052



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
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March 25, 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 Health Services and Development Agency for the period July 1, 2001, through February 28, 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 Health Services and Development Agency's compliance with laws, regulations, and provisions of contracts and grant agreements significant to the audit objectives. Management of the Health Services and Development Agency 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 resulted in no audit findings.

We have reported other less significant matters involving the agency's internal control and/or instances of noncompliance to the Health Services and Development Agency's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/eb

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Health Services and Development Agency
July 2005

AUDIT SCOPE

We have audited the Health Services and Development Agency for the period July 1, 2001, through February 28, 2005. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of equipment, revenue, expenditures, 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 serving as a member of the Health Services and Development Agency board of directors; 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.

AUDIT FINDINGS

The audit report contains no findings.

Financial and Compliance Audit Health Services and Development Agency

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Financial and Compliance Audit Health Services and Development Agency

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Health Services and Development Agency. 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 Health Services and Development Agency was created by Section 68-11-1601 et seq., *Tennessee Code Annotated*, effective July 1, 2002. The agency, which is responsible for administering the Certificate of Need program, assumed the duties of the Health Facilities Commission, which ceased to exist on June 30, 2002. The Health Services and Development Agency is responsible for regulating the health care industry in Tennessee through the Certificate of Need program created by the General Assembly. This program regulates the establishment and modification of health care institutions, facilities, and services and ensures that health care projects are accomplished in an orderly, economical manner consistent with the health care needs of the people of Tennessee. The 10-member agency is composed of the Comptroller of the Treasury, the Director of TennCare, the Commissioner of the Department of Commerce and Insurance, one consumer member appointed by the Speaker of the Senate, one consumer member appointed by the Speaker of the House of Representatives, and five members appointed by the Governor consisting of one consumer member and four industry representatives.

The duties of the agency are to issue or deny certificates of need, based on provisions of current statute, to promulgate rules as set forth in the statute, and to require the submission of periodic reports by health care institutions concerning the development of proposals subject to review under the statute. The agency employs an executive director and additional professional staff who carry out the agency’s duties.

An organization chart of the Health Services and Development Agency is on the following page.

AUDIT SCOPE

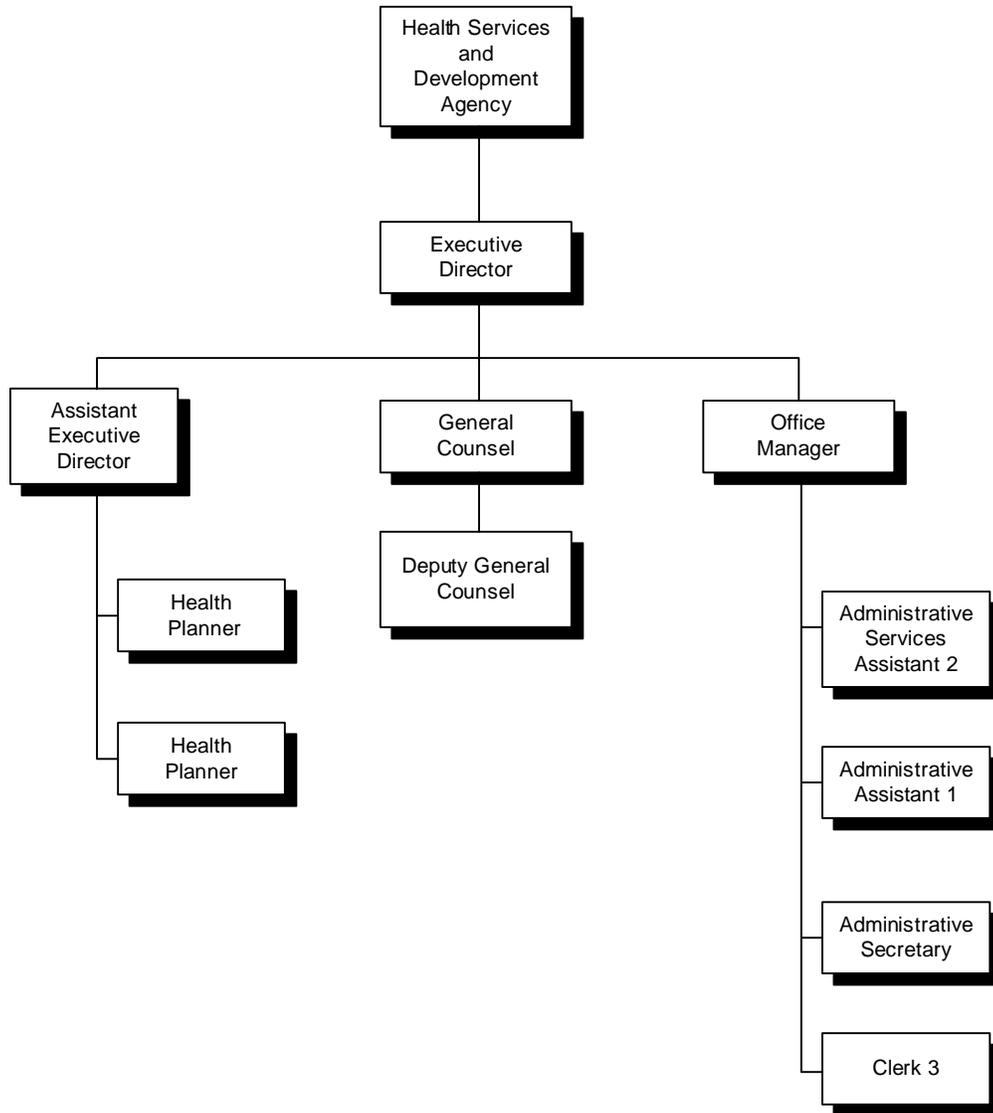
We have audited the Health Services and Development Agency for the period July 1, 2001, through February 28, 2005. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of equipment, revenue, expenditures, and the Financial Integrity Act. The audit 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 serving as a member of the Health Services and Development Agency; 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 FINDING

RESOLVED AUDIT FINDING

The current audit disclosed that the Health Services and Development Agency has corrected the previous audit finding concerning noncompliance with the Financial Integrity Act.

Health Services and Development Agency Organization Chart



OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

EQUIPMENT

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

- policies and procedures regarding equipment were adequate;
- equipment was adequately safeguarded;
- the information in the Property of the State of Tennessee (POST) system about the equipment assigned to the agency was correct; and
- access to the POST system granted to agency employees was appropriately documented, approved, and appeared reasonable based on the types of duties the employees performed.

We interviewed agency personnel and reviewed applicable policy manuals and agency rules to gain an understanding of the agency's procedures for physical security and for adding, deleting, and updating equipment information in POST. We obtained a listing of active POST equipment items from the Department of General Services as of January 2005. We selected all equipment items added to that listing during the audit period to determine whether the equipment information was properly recorded. Equipment information verified included state tag number, description, location, and serial number. We obtained a POST access listing from the Department of General Services as of August 2004 to determine which employees were recognized users and to determine their level of access. We reviewed the documentation authorizing these employees to access POST and compared their level of access with their job description.

Based on our interviews, observations, and reviews of supporting documentation, we determined that policies and procedures regarding equipment were adequate and equipment was adequately safeguarded. Based on our testwork, we determined that equipment information was properly recorded in POST and that POST access granted to agency employees was appropriately documented, approved, and appeared reasonable based on the types of duties the employees performed.

REVENUE

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

- policies and procedures regarding revenue were adequate;

- pre-numbered receipts were issued in sequence for all monies received by the agency and that copies of voided receipts were retained;
- revenue was deposited promptly, intact, and in accordance with the Department of Finance and Administration's Policy 25 concerning deposit practices;
- revenue transactions were properly supported, receipts agreed with amounts deposited, the deposit slip was properly completed, and revenue was properly recorded into the accounting system;
- agency records were reconciled with the Department of Finance and Administration revenue reports;
- administrative controls over the Certificate of Need (CON) program were adequate;
- Certificate of Need rates were calculated in accordance with agency rules and regulations; and
- refunds for the overpayment of CON fees were made in compliance with agency rules.

We interviewed agency personnel and reviewed the agency's policies to gain an understanding of the procedures and controls over revenue. We examined supporting documentation to verify that controls were operating as described by the agency including the issuance of receipt in sequence and the retention of voided receipts. We tested a non-statistical sample of cash receipts for the period July 1, 2001, through March 2, 2005, to determine whether the cash receipts were deposited promptly, intact, and as prescribed by Department of Finance and Administration Policy 25. We tested a non-statistical sample of revenue collected for the period July 1, 2001, through December 30, 2004, to determine if transactions were properly supported, receipts agreed with amounts deposited, deposit slips were properly completed, and revenue was properly recorded into the accounting system. We reviewed the agency's reconciliations of its records with the revenue reports issued by the Department of Finance and Administration. We reviewed agency regulations and administrative controls over the Certificate of Need program. We tested a non-statistical sample of CON applications processed for the period July 1, 2001, through February 14, 2005, to determine if the rates charged were properly calculated. We examined agency refunds for the overpayment of CON fees for the period July 1, 2001, through November 14, 2003, to determine if refunds were issued in compliance with agency rules.

Based on our interviews and reviews of supporting documentation, we determined that policies and procedures regarding revenue were adequate. Based on our testwork, we determined that pre-numbered receipts were issued for all monies received by the agency; voided receipts were retained; revenue was deposited promptly, intact, and in accordance with Department of Finance and Administration Policy 25; revenue transactions were properly supported, receipts agreed with amounts deposited, the deposit slip was properly completed, and revenue was properly recorded into the accounting system. We determined that the agency is

reconciling its records with the revenue reports issued by the Department of Finance and Administration. Other audit procedures revealed that the agency's administrative controls over the Certificate of Need (CON) program were adequate and that the rates for application fees were properly calculated in accordance with agency rules. Based on our testwork, we also determined that refunds for the overpayment of filing fees were issued in compliance with agency regulations.

EXPENDITURES

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

- policies and procedures regarding expenditures were adequate;
- agency records were reconciled with the Department of Finance and Administration accounting reports;
- access to the state's accounting and purchasing systems granted to agency employees was appropriately documented, approved, and appeared reasonable based on job function;
- recorded expenditures for the purchase of goods or services were adequately supported, properly authorized, in compliance with applicable state regulations, and correctly recorded in the state's accounting system; and
- payments to vendors were made promptly.

We interviewed agency personnel and reviewed supporting documentation to gain an understanding of the agency's procedures and controls over expenditures and to determine if agency records were reconciled with reports from the state's accounting system. We obtained a listing of authorized users for the State of Tennessee Accounting and Reporting System (STARS) and the Tennessee Online Purchasing System (TOPS) to determine the levels of access for agency employees. We reviewed the documentation authorizing these employees to access STARS and TOPS and compared the employees' level of access to the description of their job function. We tested a non-statistical sample of expenditures for the period July 1, 2001, through December 31, 2004, to determine whether recorded expenditures for goods and services were adequately supported, properly authorized, in compliance with applicable state regulations, and correctly recorded in the state's accounting records. Additionally, these transactions were also tested to determine if payments to vendors were made promptly.

Based on our interviews and reviews of supporting documentation, we determined that policies and procedures regarding expenditures were adequate and agency records were reconciled with reports from the state's accounting system. Other audit procedures revealed that system access to STARS and TOPS granted to agency employees was appropriately documented, approved, and appeared reasonable based on the types of duties described in the job

description and performed by the employee. Based on our testwork, we determined that recorded expenditures for goods and services were adequately supported, properly authorized, in compliance with applicable state regulations, and correctly recorded in the state's accounting system. These audit procedures also indicated that payments to vendors were made timely.

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 agency's June 30, 2004, 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 agency's evaluation of its internal accounting and administrative control was properly maintained; and
- 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*.

We interviewed employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the agency's procedures. We also reviewed the June 30, 2004, 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.

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*.

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.

AUDIT COMMITTEE RECOMMENDED

As a result of the fraud-related business failures of companies such as Enron and WorldCom in recent years, Congress and the accounting profession have taken aggressive measures to try to detect and prevent future failures related to fraud. These measures have included the signing of the *Sarbanes-Oxley Act of 2002* by the President of the United States and the issuance of *Statement on Auditing Standards Number 99* (SAS 99) by the American Institute of Certified Public Accountants. This new fraud auditing standard has not only changed the way auditors perform audits but has also provided guidance to management and boards of directors on creating antifraud programs and controls. This guidance has included the need for an independent audit committee.

As a result of these developments, we are recommending that agencies with boards establish audit committees. The specific activities of any audit committee will depend on, among other things, the mission, nature, structure, and size of each agency. In establishing the audit committee and creating its charter, each board should examine its agency's particular circumstances. Anti-fraud literature notes that there are two categories of fraud: fraudulent financial reporting and misappropriation of assets. The audit committee should consider the risks of fraud in its agency in general as well as the history of its particular agency with regard to

prior audit findings, previously disclosed weaknesses in internal control, and compliance issues. The audit committee should consider both the risk of fraudulent financial reporting and the risk of fraud due to misappropriation or abuse of agency assets. Also, the board and the audit committee should keep in mind that agencies receiving public funding should have a lower threshold of materiality than private sector entities with regard to fraud risks.

Boards should exercise professional judgment in establishing the duties, responsibilities, and authority of their audit committee. The factors noted below are not intended to be an exhaustive listing of those matters to be considered. The committee should not limit its scope to reacting to a preconceived set of issues and actions but rather should be proactive in its oversight of the agency as it concentrates on the internal control and audit-related activities of the entity. In fact, this individualized approach is one of the main benefits derived from an audit committee.

At a minimum, audit committees should:

1. Develop a written charter that addresses the audit committee's purpose and mission, which should be, at a minimum, to assist the board in its oversight of the agency.
2. Formally reiterate, on a regular basis, to the board, agency management, and staff their responsibilities for preventing, detecting, and reporting fraud, waste, and abuse.
3. Serve as a facilitator of any audits or investigations of the agency, including advising auditors and investigators of any information they may receive or otherwise note regarding risks of fraud or weaknesses in the agency's internal controls; reviewing with the auditors any findings or other matters noted by the auditors during audit engagements; working with the agency management and staff to ensure implementation of audit recommendations; and assisting in the resolution of any problems the auditors may have with cooperation from agency management or staff.
4. Develop a formal process for assessing the risk of fraud at the agency, including documentation of the results of the assessments and assuring that internal controls are in place to adequately mitigate those risks.
5. Develop and communicate to staff of the agency their responsibilities to report allegations of fraud, waste, or abuse at the agency to the committee and the Comptroller of the Treasury's office as well as a process for immediately reporting such information.
6. Immediately inform the Comptroller's office when fraud is detected.
7. Develop and communicate to the board, agency management, and staff a written code of conduct reminding those individuals of the public nature of the agency and the need for all to maintain the highest level of integrity with regard to the financial operations and any related financial reporting responsibilities of the agency; to avoid preparing or issuing fraudulent or misleading financial reports or other information; to protect agency assets from fraud, waste, and abuse; to comply with all relevant

laws, rules, policies, and procedures; and to avoid engaging in activities which would otherwise bring dishonor to the agency.

The charter of the audit committee should include, at a minimum, the following provisions:

1. The audit committee should be a standing committee of the board.
2. The audit committee should be composed of at least three members. The chair of the audit committee should preferably have some accounting or financial management background. Each member of the audit committee should have an adequate background and education to allow a reasonable understanding of the information presented in the financial reports of the agency and the comments of auditors with regard to internal control and compliance findings and other issues.
3. The members of the audit committee must be independent from any appearances of other interests that are in conflict with their duties as members of the audit committee.
4. An express recognition that the board, the audit committee, and the management and staff of the agency are responsible for taking all reasonable steps to prevent, detect, and report fraud, waste, and abuse.
5. The audit committee should meet regularly throughout the year. The audit committee can meet by telephone, if that is permissible for other committees. However, the audit committee is strongly urged to meet at least once a year in person. Members of the audit committee may be members of other standing committees of the board, but the audit committee meetings should be separate from the meetings of other committees of the board.
6. The audit committee should record minutes of its meetings.

The Division of State Audit will be available to discuss with the board any questions it might have about the creation of its particular audit committee. There are also other audit committees which have already been established at other state agencies that the board may wish to contact for advice and further information.