AUDIT REPORT

Tennessee Arts Commission

July 2006

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
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John G. Morgan
Comptroller

July 27, 2006

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Mr. Rich Boyd, Executive Director
Tennessee Arts Commission
401 Charlotte Avenue
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Arts Commission for the period July 1, 2001, through May 31, 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
05/079

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COMPTROLLER OF THE TREASURY
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June 23, 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 Arts Commission for the period July 1, 2001, through May 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 Tennessee Arts Commission's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Tennessee Arts Commission 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 commission'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 commission's internal control and/or instances of noncompliance to the Tennessee Arts Commission'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
Tennessee Arts Commission
July 2006

AUDIT SCOPE

We have audited the Tennessee Arts Commission for the period July 1, 2001, through May 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, inventory, vehicle registration revenue, Department of Finance and Administration Policy 20 – "Recording of Federal Grant Expenditures and Revenues," 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.

AUDIT COMMITTEE

On May 19, 2005, the Tennessee General Assembly enacted legislation known as the "State of Tennessee Audit Committee Act of 2005." This legislation requires the creation of audit committees for those entities that have governing boards, councils, commissions, or equivalent bodies that can hire and terminate employees and/or are responsible for the preparation of financial statements. Entities, pursuant to the act, are required to appoint the audit committee and develop an audit committee charter in accordance with the legislation. The ongoing responsibilities of an audit committee include, but are not limited to:

1. overseeing the financial reporting and related disclosures, especially when financial statements are issued;

2. evaluating management's assessment of risk and the agency's system of internal controls;
3. formally reiterating, on a regular basis, to the board, agency management, and staff their responsibility for preventing, detecting, and reporting fraud, waste, and abuse;
4. serving as a facilitator of any audits or investigations of the agency, including advising auditors and investigators of any information it may receive pertinent to audit or investigative matters;
5. informing the Comptroller of the Treasury of the results of assessment and controls to reduce the risk of fraud; and
6. promptly notifying the Comptroller of the Treasury of any indications of fraud.

Subsequent to the completion of fieldwork, the Tennessee Arts Commission created a five-member audit committee at its quarterly meeting on March 8, 2006. On June 8, 2006, the commission approved the audit committee charter. The audit committee charter was approved by the Comptroller of the Treasury on July 6, 2006.

In meeting their responsibilities, the audit committee should ensure that top management of the commission timely and effectively address the many weaknesses noted in this audit. The risk assessment to be performed and documented by top management should consider all other business risks and risks of fraud, waste, and abuse to the commission, in addition to those noted in this audit report.

AUDIT FINDINGS

The Commission's Management Failed to Monitor the Implementation of Procedures Necessary to Mitigate the Risks Associated With Controlling and Safeguarding Museum Artifacts*
As noted in the prior audit, the Tennessee State Museum does not take a physical inventory of museum artifacts (page 5).

The Commission's Management Failed to Implement Procedures Necessary to Mitigate the Risks Associated With Controlling and Safeguarding Equipment
The Property of the State of Tennessee manual, Appendixes B and C, contains guidelines for adding, safeguarding, and accounting for equipment. However, the commission did not adhere to these guidelines (page 9).

Donation Collections Not Recorded in Compliance With *Tennessee Code Annotated*
Donations for the Tennessee State Museum that are received at donation boxes in the James K. Polk and War Memorial Buildings are incorrectly coded as deferred revenue (page 12).

Management of the Tennessee Arts Commission and the Tennessee State Museum Have Not Adequately Addressed the Risks Associated With Inadequate Accounting Controls and Did Not Mitigate the Risk of Theft, Misappropriation of Assets, and Improper Purchases
Accounting controls at both the Arts Commission and the State Museum are not adequate. Deficiencies were noted with

segregation of duties, internal control procedures, maintenance of adequate documentation, and the billing process (page 13).

The Tennessee State Museum Did Not Follow Purchasing Procedures, Increasing the Risk of Inappropriate or Unauthorized Purchases

The Tennessee State Museum did not always comply with the Department of General Services Purchasing Procedures when purchasing artifacts and renting exhibitions (page 20).

The Tennessee Arts Commission Did Not Ensure That Its Subrecipient Contracts Were Monitored in Compliance With Finance and Administration Policy 22, Reflecting a Weak Internal Control Environment and Increasing the Risk That Noncompliance With Contract Provisions Could Occur and Not Be Detected

The Tennessee Arts Commission did not submit a subrecipient contract monitoring plan by October 1, 2004, as required by Department of Finance and Administration Policy 22. The monitoring plan and the monitoring performed by the commission also did not comply with Policy 22 (page 22).

For the Sixth Consecutive Audit, the Commission Did Not Mitigate the Risk of Inadequate Recording of Federal Grants Expenditures and Revenues and Failing to Draw Down Federal Funds on a Timely Basis in Compliance With Finance and Administration Policy 20**

For the sixth consecutive audit, the Tennessee Arts Commission did not comply with the Department of Finance and Administration's Policy 20, "Recording of Federal Grants Expenditures and Revenues." The commission did not make monthly drawdowns of federal funds as required by Policy 20 (page 28).

As Noted in the Prior Audit, the Commission Does Not Have Internal Controls Over the Accounting and Expenditure of Funds From the Sale of New Specialty Earmarked Vehicle Registration Plates*

As noted in the prior audit, the Tennessee Arts Commission does not have an internal control system in place to ensure compliance with Section 55-4-215, *Tennessee Code Annotated*, which prescribes requirements for the distribution of new specialty earmarked motor vehicle registration plate revenue (page 33).

The Executive Director Did Not Provide Any Guidance to Employees of the Tennessee Arts Commission and the Tennessee State Museum Regarding Conflicts of Interests Responsibilities and Failed to Ensure the Entities Were in Compliance With State Law and the Governor's Executive Order on Ethics and Conflicts of Interest

The Executive Director of the Tennessee Arts Commission did not instruct employees to complete ethics policy forms or conflict-of-interest statements as required by Executive Order No. 3 and *Tennessee Code Annotated* (page 36).

As Noted in the Prior Audit, the Commission Did Not Comply With the Financial Integrity Act*

The commission did not comply with the Financial Integrity Act by preparing or submitting letters acknowledging responsibility for maintaining the internal control system (page 40).

SPECIAL INVESTIGATIONS FINDINGS

The Tennessee Arts Commission Did Not Require the Repayment of $2,700 From the Tennessee Arts Foundation

The Executive Director did not require the Tennessee Arts Foundation to return funds collected for the 2004 Tennessee Stages Tennessee Stars conference to the state (page 43).

Purchases of Three Chairs Totaling $722.93 Were Misrepresented to Circumvent Purchasing Policies and Procedures

The museum staff improperly treated the transactions as three separate purchases, each under $400, and did not obtain three bids as required (page 48).

* This finding is repeated from the prior audit.

** This finding is repeated from prior audits.

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Tennessee Arts Commission

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INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Tennessee Arts Commission. 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.

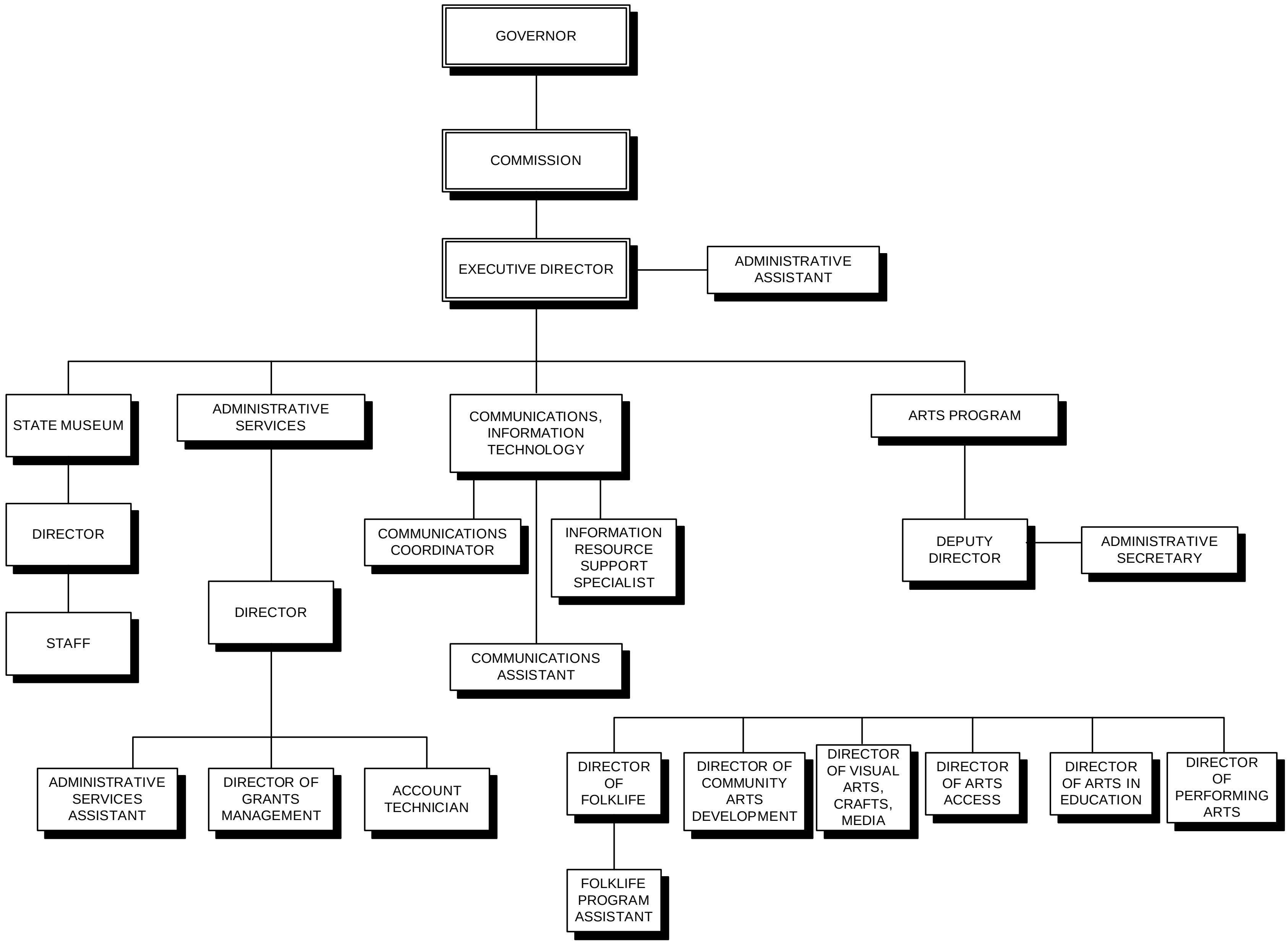
BACKGROUND

The mission of the Tennessee Arts Commission is to ensure the citizens of the State of Tennessee have access to and participate in the arts. In addition to its responsibility for and to the arts and artists in Tennessee, the Arts Commission has supervisory and administrative responsibility for the Tennessee State Museum.

The Tennessee Arts Commission is governed by a commission board. The board's 15 members are appointed by the Governor and are to be broadly representative of all fields of the arts. At least one member, but not more than two, is appointed from each United States congressional district in Tennessee. Terms of appointment are five years. Members of the commission who complete a five-year term cannot be reappointed until a full year has passed. The commission is assisted in its efforts by an advisory panel composed of interested citizens and artists. The commission chair, with the approval of the commission, is responsible for employing an Executive Director as administrative officer. The Executive Director in turn is responsible for employing all other staff members needed for operations.

An organization chart of the Tennessee Arts Commission is on the following page.

Tennessee Arts Commission
Organization Chart



AUDIT SCOPE

We have audited the Tennessee Arts Commission for the period July 1, 2001, through May 31, 2005. Our audit scope included a review of internal control and compliance with laws, regulations, and provisions of contracts or grant agreement in the areas of revenue, expenditures, equipment, inventory, vehicle registration revenue, Department of Finance and Administration Policy 22 – "Recording of Federal Grant Expenditures and Revenues," 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.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Tennessee Arts Commission filed its report with the Department of Audit on February 3, 2003. A follow-up of all prior audit findings was conducted as part of the current audit.

REPEATED AUDIT FINDINGS

The prior audit report contained findings concerning compliance with the Financial Integrity Act, inventory policies and procedures, internal controls over the accounting and expenditure of funds from the sale of the new specialty earmarked vehicle registration plates, and late drawdowns of federal funds. These findings have not been resolved and are repeated in the applicable sections of this report.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

ARTIFACTS INVENTORY

The objectives of the review of the Tennessee Arts Commission's inventory controls and procedures over artifacts were to determine whether

- policies and procedures regarding inventory are adequate,
- a physical inventory of items on the property listing represents a complete and valid listing of the assets physically on hand,
- inventory purchased during the audit period was properly added to the property listing,
- inventory items are adequately safeguarded,
- lost or stolen inventory was properly reported to the Comptroller's office and deleted from the property listing, and
- an annual inventory was performed during the audit period.

We interviewed key personnel and reviewed supporting documentation to gain an understanding of the commission's procedures and controls over inventory. We reviewed supporting documentation and tested a nonstatistical sample of artifacts purchased during the audit period recorded on the State of Tennessee Accounting and Reporting System. In addition, we tested selected artifact items from the museum. Artifacts were physically located, and the price of purchase, description, object identification number, condition, and location were traced to the property records. Also, we determined if artifact items were charged to the correct object code and whether lost or stolen artifacts were properly reported.

We determined that information on the property listing was substantially accurate and complete, inventory purchased during the audit period was properly added to the property listing, artifacts appeared to be adequately safeguarded, and lost or stolen inventory was properly reported to the Comptroller's office and deleted from the property listing. However, based on interviews, review of supporting documentation, and testwork, it appears that the policies and procedures related to inventory are not adequate, an annual physical inventory was not performed, and the physical location of artifacts is not always recorded properly in the department's inventory recording system, as noted in finding 1.

1. **<u>The commission's management failed to monitor the implementation of procedures necessary to mitigate the risks associated with controlling and safeguarding museum artifacts</u>**

Finding

As noted in the prior audit, the Tennessee State Museum does not take a physical inventory of museum artifacts. The museum has not taken a physical inventory of artifacts since June 1999. Management concurred with the prior audit finding stating, "…the museum registrar is developing an internal system that will generate a valid random sampling of the collection based upon location data." However, management did not adequately monitor staff to ensure that the system was developed, and random sampling of the collection was never implemented. The current process only includes observation of artifacts removed from storage for exhibition or photographic purposes. There are no procedures for a periodic physical inventory. When artifacts are not subject to periodic observation, the potential for timely detecting lost or stolen artifacts is greatly diminished and the potential for misappropriation or theft is greatly increased.

Three separate samples of artifacts were selected. Sixty items were randomly selected from the artifacts inventory records to ensure that the items could be located and that the information in the records was correct, an additional 60 artifacts were selected by observation in the storage and exhibit areas and traced to inventory records, and an additional 60 artifact purchases were selected from the expenditure records and traced to inventory records. All of the artifacts were located; however, the following errors were noted.

- Sixteen artifacts were not in the locations noted in the inventory records.
- Five artifacts did not have an identifying accession number affixed to the artifacts.

Recommendation

With the Executive Director's approval, the Museum Director should develop and implement inventory policies and procedures in which random samples are selected for observation from the entire population of artifacts. These procedures should be designed to prevent material losses and detect such losses in a timely period should they occur. Sampling strategies should be based on management's assessment of risks for loss or theft, and focus on items located outside of the museum's immediate control. When artifacts are moved, the museum staff should be notified timely in order for information in the artifact inventory records to be updated. In addition, artifacts should not be exhibited until the accessioning process has been completed, which includes the affixing of an accession number to the artifact and recording the item in the artifact inventory records.

Management should ensure that risks such as these noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

Management's Comment

We concur with explanation. While the Tennessee Arts Commission has oversight of the Tennessee State Museum, the two agencies have separate missions, operate under two separate budget allotment codes, and are staffed with different employees who have training and expertise specific to the operation of their agency.

The Commission has established an Audit Committee as required by Section 4-35-101, *Tennessee Code Annotated*, that will work with the Museum staff to periodically review any audit findings and take appropriate effective measures to ensure that all staff of the Museum recognizes the importance of complying with state policies and procedures.

The Museum Director will work with designated Museum staff to develop and implement inventory policies and procedures that will protect the Museum's assets from fraud, waste or abuse. These policies and procedures will be reviewed by the Executive Director of the Commission and audit committee. In the development process the Museum staff will address the audit finding:

Inventory Maintenance

The Museum's inventory of its collection will be maintained through routine updating of automated records.

1. For objects located within the Tennessee State Museum, the Museum's ARGUS data management system is the information system of record for maintaining object locations to the room or exhibit area, and may be used for recording more specific locations. An object's specific location within a storage room or exhibit area is recorded in the Museum's ARGUS system.
2. For objects located at facilities other than the Tennessee State Museum, the Museum's ARGUS system is the system of record for maintaining object locations coded to the facility. The facility manager and/or borrower are responsible for maintaining more specific locations.

Cyclical Inventories

1. Locations of highly sensitive objects will be verified on an annual basis, either through spot check verification or 100% verification.
2. All loans to the Museum are inventoried fully at the time of loan renewal or loan termination.

3. Locations of less sensitive objects will be spot-checked on a bi-annual basis. Data in 2% to 3% of the records documenting a particular group of objects is compared against the objects documented therein, including verifying locations.
4. Each defined Museum collection of objects will be inventoried either fully or spot-checked once every 10 years. The Museum's collection is divided into the following departmental groups: Art and Architecture; Cultural History; Fashion and Textiles; Military History; National Civil Rights Museum; Native American; Natural Science; and Science and Technology.

Reconciliation

ARGUS records will be reconciled with previously existing records when an object is first involved in any of the following:

1. Off-site relocations
2. Tennessee State Museum exhibits
3. Outgoing loans

Authority and Responsibility

1. The Museum Registrar will be responsible for developing, implementing, and monitoring a coordinated Cyclical Inventory Plan for the Tennessee State Museum, within the constraints of available resources.

2. Collections Department staff will manage assigned collection storage areas and record object movement into, within, and out of these storage areas. They will verify object records in ARGUS with previously existing records.

3. The Museum's registration staff will manage any off-site storage in use by the Museum and records object movement into, within, and out of these off-site facilities. They will manage the Museum's packing and shipping of objects and records object movement into and out of the Tennessee State Museum.

4. Exhibit staff will manage exhibition staging areas and the installation and de-installation of objects. Collections Department staff record object movement into, within, and out of staging areas and exhibit sections.

Accountability

1. Highly sensitive objects having a value above $25,000.00 will be reported to the state's Risk Management Administrator annually.

2. Inventory checks will be administered by non-Collections Department staff who are not assigned any physical control over any Tennessee State Museum object.

Definitions

Inventory is an itemized listing of objects or groups of objects in the museum collection that identifies the current physical location of each object or group; the process of physically locating all or a selection of objects for which the museum is responsible; and appropriate information to facilitate research, collections management, security, and access.

Cyclical Inventory is a planned inventory of collection objects, conducted according to a predetermined schedule. Cyclical inventories may include a complete inventory or a specific percentage or sampling of the entire collection inventory as predetermined using statistically sound inventory methods.

Highly Sensitive Objects are objects requiring a higher level of physical security because of their material composition, current market value, historical importance, or other risk factors.

EQUIPMENT

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

- policies and procedures related to equipment were adequate,
- the information on the commission's equipment listed in the Property of the State of Tennessee (POST) system is accurate and complete,
- property and equipment are adequately safeguarded,
- equipment purchased during the audit period was properly recorded in POST, and
- lost or stolen equipment was properly reported to the Comptroller's office and deleted from the commission's property listing.

We interviewed key personnel and reviewed supporting documentation to gain an understanding of the commission's procedures and controls over equipment. We reviewed supporting documentation and selected nonstatistical samples of equipment from the POST equipment listing and equipment purchases recorded on the State of Tennessee Accounting and Reporting System (STARS). In addition, we tested selected items from the office of the commission. Equipment items were physically located, and description, tag number, serial number, and location were traced to the POST listing. For the items tested that were purchased during the audit period, the cost recorded in STARS was traced to supporting documentation and the POST inventory listing. We determined whether lost or stolen equipment was properly reported and deleted from POST by reviewing supporting documentation.

Based on interviews, review of supporting documentation, and testwork, it appears that the department's equipment policies and procedures are adequate. We determined that property and equipment are overall adequately safeguarded with some exceptions. However, we determined that procedures were not always followed. As a result, the property listing is not always accurate and complete, and equipment purchased during the audit period was not always recorded properly in POST.

2. <u>The commission's management failed to implement procedures necessary to mitigate the risks associated with controlling and safeguarding equipment</u>

Finding

The commission needs to improve its accountability over equipment. The Property of the State of Tennessee (POST) manual, Appendixes B and C, contains guidelines for adding, safeguarding, and accounting for equipment. However, the commission's management did not monitor staff to ensure adherence to these guidelines.

Three separate samples of equipment items were selected. Sixty-one equipment items were randomly selected from the POST equipment records to ensure that the equipment could be located and that the information in POST was correct, 49 equipment items were selected by observation and traced to POST equipment records, and 45 equipment purchases were selected from the expenditure records and traced to POST equipment records. As a result of the testwork, the following errors were noted.

- One item could not be located.
- Three items did not have serial numbers recorded in POST.
- One item had two state property tags attached, and both tag numbers were included in POST. Since the item was recorded twice in POST, the item's value was counted twice.
- One item was not in the location noted in POST.
- Ten items had incorrect serial numbers recorded in POST. It appeared that the errors were either due to typos, transposed numbers, or not all of the numbers/letters being recorded.
- Five items had state tags attached, but the items were no longer listed in POST.
- One item was defective and returned to the manufacturer, but the defective item was not removed from POST, and its replacement was never tagged or added to POST.
- Three items did not have state tags attached.

When fixed assets records are not accurate, there is an increased risk of items being lost or stolen without notice and not being reported or staff inappropriately reporting items as lost or stolen and the error not being detected timely. From the period June 14, 2002, through June 30, 2004, the department reported to the Comptroller's Office that 41 equipment items costing $28,373.01 were either lost or stolen. Some of these recorded losses could be attributed to management's failure to monitor staff to ensure the accuracy of the property records and the safeguarding of equipment.

Recommendation

The Executive Director should ensure that established equipment policies and procedures are followed. When equipment is moved, transferred, surplused, or reported lost or stolen, the proper forms should be completed and the property officer should be notified in order for the information in POST to be updated. In addition, the commission should perform a thorough inventory (which includes verification of serial numbers) for all locations where equipment is maintained. Equipment should be adequately safeguarded to avoid losses due to theft. Furthermore, the property officer should verify additions, deletions, and other changes to POST to reduce confusion during inventory and to improve accountability over equipment.

The Executive Director should ensure that risks such as these noted in this finding are adequately identified and assessed in the commission's documented risk assessment activities. The Executive Director, with the assistance of his management staff, should design and implement internal controls to mitigate those risks to prevent and detect exceptions timely. These controls should be thoroughly documented and also identify staff to be responsible for ongoing monitoring for compliance with all requirements and provide appropriate steps for taking prompt action should exceptions occur. The documented risk assessment and the mitigating controls should be presented to the commission's audit committee for their review and approval. The commission's audit committee should carefully and thoughtfully review the risk assessment and the controls, including seeking clarification from the Executive Director regarding any matters the audit committee does not understand. The members of the audit committee, on behalf of the full commission, should also provide input to the Executive Director regarding any additional risks to the entity they believe should be a part of the risk assessment and any additional controls they believe are necessary. The audit committee should document their review and approval of the risk assessment and the mitigating controls.

The auditors will study the documentation of the risk assessment and the mitigating controls, and their review and approval by the audit committee, as part of the auditor's planning and risk assessment for the next audit.

Management's Comment

We concur. The Commission's management and the Museum's management failed to implement procedures necessary to mitigate risks associated with controlling and safeguarding equipment.

While the Tennessee Arts Commission has oversight of the Tennessee State Museum, the two agencies have separate missions, operate under two separate budget allotment codes, and are staffed with different employees who have training and expertise specific to the operation of their agency; therefore, each entity will address the finding differently. Ultimately, the audit committee will review both the Commission and Museum policies and procedures to address and eliminate this finding.

Commission Response

The Commission will establish policies and procedures to mitigate the risks connected with controlling and safeguarding equipment. The Executive Director has assigned this responsibility to the Administrative Services Director that will be reviewed by the audit committee. These include:

- All Commission equipment will be inventoried on an annual basis to monitor if it has been moved, transferred, surplused or reported lost or stolen by updating in POST. Two different members of the staff will be involved and sign off on completion of this process.
- The process will include an annual inventory monitoring to verify correct serial numbers and be included as part of the Commission's risk assessment activities.

Museum Response

The Museum Director will develop and implement procedures to improve its accountability for equipment that will be reviewed by the Executive Director and audit committee. As a result of audit concerns, an additional staff person will be added to the Museum's administrative support work group. This position, effective July 1, 2006, will share in the responsibility of equipment inventory and tracking. An additional staff person should result in a more equitable distribution of work, which in turn should result in greater attention to detail and fewer human errors.

Many of the specific items noted have already been rectified. Specifically, the video recorder located at the National Civil Rights Museum was removed from service for repair. It was discovered that the parts were no longer obtainable. This item will be officially removed from the state's inventory during the forthcoming planned report prior to June 30, 2006. All typographical errors in POST have been addressed. Three printers, which were missing state tags, have been appropriately tagged. The manufacturer's replacement for a defective printer has also been appropriately tagged.

REVENUE

The objectives of the review of the commission's revenue controls and procedures were to determine whether

- policies and procedures relating to revenue were adequate,
- revenue transactions were properly recorded and supported,
- cash collected during the audit period was deposited timely,
- physical controls over cash were adequate,
- revenue or fees were billed or charged and recorded at the correct amount,

- procedures concerning donation box collections were adequate and were followed,
- donation box collections were properly accounted for and deposited timely,
- petty cash or change funds were authorized by the Department of Finance and Administration and funds were properly accounted for, and
- commission records were reconciled with Department of Finance and Administration reports.

We interviewed key personnel to gain an understanding of the commission's procedures and controls over revenue. We tested a nonstatistical random sample of revenue items, a listing of cash receipts, and a nonstatistical sample of donation box collections to determine if deposits were made timely, transactions were properly recorded, and procedures were followed. Also, we determined whether petty cash or change funds were properly authorized and funds were properly accounted for.

Based on interviews and review of controls, cash collected during the audit period was deposited timely, procedures concerning donation box collections were adequate and were followed, donation box collections were deposited timely, and petty cash or change funds were authorized by the Department of Finance and Administration.

However, we determined that donation box collections are not properly accounted, as noted in finding 3. We also determined that policies and procedures related to revenue and controls over cash are not adequate, there were weaknesses with revenue billings and maintenance of proper support, and records are not reconciled with Department of Finance and Administration reports; all are included in finding 4.

3. <u>Donation collections not recorded in compliance with *Tennessee Code Annotated*</u>

Finding

Donations for the Tennessee State Museum that are received at donation boxes in the James K. Polk and War Memorial Buildings are incorrectly coded as deferred revenue. Section 4-12-102(c)(2), *Tennessee Code Annotated,* states,

> The Museum Director shall install and maintain suitable containers for the collection of small cash donations to the state museum. The funds so collected shall be receipted and deposited as departmental revenue of the museum with the same budgetary and accounting controls as other funds of the Museum.

Donations are received from visitors to the State Museum and War Museum. The money from the boxes is counted and deposited once or twice a month. Total donation box revenue for the audit period was $17,769.91.

Museum personnel referred to 2004 Public Acts Chapter 961, Section 4, as the basis for classifying the revenue as deferred. However, based on review, this act is in agreement with *Tennessee Code Annotated*. Section 4 of this act states,

> For the purpose of this section 'departmental revenues' are defined as . . . (2) donations, contributions, or participation by political subdivisions, foundations, corporations, firms or persons.

When donations are recorded as deferred revenue instead of departmental revenue, any unspent portion is not reverted back to the state's General Fund but is maintained by the museum. Unspent donations should be returned to the General Fund.

Recommendation

Museum personnel should ensure that donation box revenue is properly recorded as departmental revenue in accordance with *Tennessee Code Annotated*.

Management's Comment

We concur. Donation collections are not recorded in compliance with *Tennessee Code Annotated.*

On February 8, 2006, Museum staff consulted with the Department of Finance and Administration to develop a procedure for the disposition of donation box revenue with the goal of making all such revenue properly recorded in compliance with *Tennessee Code Annotated*.

4. Management of the Tennessee Arts Commission and the Tennessee State Museum have not adequately addressed the risks associated with inadequate accounting controls and did not mitigate the risk of theft, misappropriation of assets, and improper purchases

Finding

Accounting controls at both the Arts Commission and the State Museum are not adequate. Deficiencies were noted with segregation of duties, internal control procedures, maintenance of adequate documentation, and the billing process.

Inadequate segregation of duties in the receipting and expenditure processes were noted at both the commission and the museum.

- At the commission, one employee writes the cash receipts, prepares the mail log, prepares the deposit, takes the deposit to the bank, and posts the cash receipt information to the accounting records. The same individual is responsible for investigating any disputed items, unidentified receipts, Non Sufficient Funds checks, outstanding purchase orders, and any other questionable items.

- In addition to the segregation-of-duties issues over the commission's receipting process, the same employee serves as the commission's purchasing and Property of the State of Tennessee (POST) property officer. Furthermore, the employee has a level of access in the Tennessee Online Purchasing System (TOPS) which allows the following: entering requisitions and purchase orders into the system, entering invoice information for purchase orders to be paid, approving a purchase order for payment, recording the receipt of items purchased, and entering a change transaction to cancel an encumbered purchase order.
- At the museum, one employee records the amount of the checks into the Incoming Funds Log, prepares the deposit, and posts the deposit information to the accounting records. The same individual also investigates any disputed items, Non Sufficient Funds checks, outstanding purchase orders, and any other questionable items.
- In addition to the segregation-of-duties issues over the museum's receipting process, the same employee serves as the museum's purchasing and POST property officer. Furthermore, the employee also has a level of access in TOPS which allows the following: entering requisitions and purchase orders into the system; entering invoice information for purchase orders to be paid; approving a purchase order for payment; recording the receipt of items purchased; approving orders and requisitions for a department, group of departments, or group of commodities; and entering a change transaction to cancel an encumbered purchase order.

The lack of segregation of duties was further evidenced during our testwork. Forty-three of 60 expenditure items tested (72%) did not have evidence that more than one employee was involved in the purchase and approval process. Several of these items indicated the administrative director's approval; however, this approval was signed by the account technician. This account technician also initiated the purchase order, entered payment information into the State of Tennessee Accounting and Reporting System (STARS), and received the goods.

Inadequate segregation of duties can result in theft, misappropriation of assets, and improper purchases including purchases for personal use. Independent reviews and reconciliations serve as compensating controls and provide additional ways of checking for any discrepancies, especially when the other functions are only performed by one or a few individuals. The commission and museum do not have adequate compensating controls in place to mitigate the above weaknesses. Independent documented comparisons are not made between the mail logs, cash receipt records, and the deposit documentation. Also, there is no independent documented comparison made between the cash receipt records and monthly STARS revenue reports (STARS 808-Estimated versus Actual Revenue and STARS 840-Monthly Revenue Transactions) received by the commission from the Department of Finance and Administration.

Additional evidence of the lack of mitigating controls was observed during testwork. Neither the commission nor the museum makes periodic independent documented reconciliations between contract payments and payments posted to STARS. For three of three contract items tested (100%), reconciliation was not performed. In addition, no one independent of the account technician at either the commission or the museum performs a regular, documented reconciliation of POST to STARS. This type of reconciliation could be used as a compensating control when proper segregation of duties is not practicable. Periodic independent documented reconciliations of contact payments recorded in the commission's and museum's records to the Department of Finance and Administration's payment records can lessen the risk of undiscovered accounting errors, fraud, waste, or abuse and overpayment of contract agreements.

In addition to the lack of segregation of duties, the commission does not appropriately restrict and terminate access rights to its property records. A former commission employee still had access to POST. This former employee transferred to the Department of Health on November 1, 2000. In addition, one current employee at the museum had access to POST but did not have property responsibilities, and one former employee who left state employment on May 30, 2003, still had POST access. The Office for Information Resources *Security Standards, Granting Access to Information* states, "Remove access rights immediately upon termination." Failure to terminate access rights increases the risk that unauthorized activities including fraud, waste, and abuse could occur and not be detected in a timely manner.

It was also observed that the commission and the museum do not always maintain adequate documentation for all accounting transactions. During testwork, auditors noted the following discrepancies:

- Two of 60 revenue items tested (3%) were not properly supported. One of the two noted was a $2,700 reimbursement check for conference fees and t-shirt sales received from the Tennessee Arts Foundation (see finding 11); a copy of the check, in support of the amount deposited, was not maintained. For the other item, a receipt was not written for an $89.38 return of an overpayment.

- The original approved copy of Journal Voucher 123297 in the amount of $49,812.50 could not be located by the commission or the museum. Based on discussion with management, commission personnel thought the museum had the copy, and the museum personnel thought the commission had the copy. The information on file, which was incomplete, indicated the payment was from the commission to the museum for an exhibition of works of art titled "Best of Tennessee."

- The museum did not maintain adequate support for any automatic billings or entries from Finance and Administration. Such billings primarily consist of STARS billings and any applicable journal entries made. Adequate support could not be located for the 5 automatic billings (totaling $337) in our sample of 65 expenditure items (8%).

- Although no instances of duplicate payments were noted during our review, controls were not in place to prevent duplicate payments for goods and services. For 16 of 54 expenditure items tested for adequate documentation (30%), the invoices, journal vouchers, and other supporting documentation were not stamped paid or otherwise documented to prevent duplicate payment.

A lack of adequate documentation in support of transactions could result in accounting errors, interdepartmental or vendor inquiries that cannot be properly researched or solved, duplicate payments, duplicate billings, and other problems, including fraud, waste, or abuse.

Also, one instance was noted where the museum billed another department twice for the same item, and payment was received both times. The billings relate to purchases made in the museum gift shop by an employee of the Department of Health on August 3, 2001. The first billing (Journal Voucher 123299) was made on October 23, 2001. Payment was processed on November 14, 2001. The second billing (Journal Voucher 050354) was made on June 28, 2002. Payment was processed on August 8, 2002. Each of these billings was in the amount of $130.50. Museum accounting personnel were not sure how this occurred.

Recommendation

In order to appropriately address the risks associated with inadequate accounting controls, duties should be segregated to prevent the same individual from performing incompatible functions. Employees with TOPS access should not have the authority to initiate, receive, or approve purchases. When attempts to segregate duties fail, effective compensating controls must be in effect to prevent and detect fraud, waste, and abuse. Audit experience has consistently shown that a lack of segregation of duties is a prime contributor to fraud, waste, and abuse. As such, circumstances in which management does not maintain adequate segregation of duties, regardless of the reason, represent enhanced risks of fraud, waste, and abuse. Furthermore, when problems are noted in such circumstances, the individual handling all the transactions is placed in a position of having to defend and explain any transactions appearing unusual. And, due to the risk associated with a lack of segregation of duties, these staff may expect more auditor scrutiny of their activities.

Hence, it is essential top management treat these situations with utmost care so staff are not placed in such compromising positions, or if they are, to impress upon staff that all transactions are to be adequately supported. Top management must also take steps to ensure the transactions are subjected to meaningful review in an effort to provide appropriate compensating controls. As part of those controls, the compensating control activities—reconciliations, reviews, and testing of transactions—must be well documented and performed on a regular basis. Any unsupported, odd, or unusual transactions must be thoroughly investigated and reported to top management. The activities to be performed should include such things as making a comparison between the mail log, the cash receipt records, and the deposit documentation by an employee independent of these functions. Someone should independently reconcile the agency's records of contract expenditures to STARS on a monthly basis. In addition, POST and STARS should be reconciled on a monthly basis by someone that does not have property responsibilities. Cash receipts should be prepared for all revenue received. The Executive Director should develop and implement procedures to ensure that employees' access to state computer systems is independently reviewed periodically to determine if the level of access is appropriate and necessary to perform their job duties. Access should be immediately revoked upon employee termination. Adequate documentation should be maintained including receipts, checks, copies of the back of original checks, journal vouchers, support for Finance and Administration billings, evidence of independent approvals for purchases, and evidence to preclude duplicate payments. The museum should take the necessary measures to ensure that duplicate billings do not occur.

In all situations, whether or not appropriate segregation of duties is maintained, the control activities should provide for regular monitoring to ensure documents are being maintained and that exceptions are promptly investigated.

Management should ensure that risks such as these noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

Management's Comment

The Commission and State Museum management recognizes the need to address risks with adequate accounting controls. It should be noted that both entities operate with a limited number of administrative services positions and these individuals are assigned multiple financial responsibilities. Previously required budget reductions have caused the elimination of accounting and administrative positions which are essential in segregating duties, establishing individual control procedures and maintaining adequate documentation.

Commission Response

Recognizing the need to address identified risks, the Executive Director has implemented procedures to address risks by segregating duties and establishing accounting internal controls. These include:

- A meaningful review by at least two Commission staff will be performed before any purchases are initiated or approved by the Commission.

- A procedure for opening mail containing checks has been implemented that involves:

    1) Designated staff opening mail, date clocks mail and checks and bank stamps back of check, making three copies of both front and back of check along with registration form that may accompany check.

    2) Staff logs in received check with appropriate information. Original check and one copy of registration form is routed to account technician for processing. One copy of check and registration form is routed to Arts Program Secretary for entry into registration book. One copy of check and registration form is routed to conference coordinator.

    3) Administrative Assistant sends receipt for check to sender.

4) Account Technician logs in check and prepares deposit slip and routes to the Director of Administrative Services for deposit.

- The administrative services director has been assigned to develop procedures to monitor internal control activities including contract expenditures to STARS on a monthly basis.
- The Executive Director has implemented a review process with the agency's information technology director to determine appropriate access to the state computer system and to review this access on a periodic basis.
- Upon the termination of a Commission employee, the information technology director will be notified to proceed with removing access rights to POST and report back to the Executive Director when completed.
- The administrative services director has been assigned to develop procedures to address audit findings and document them as part of the agency's risk assessment policies.
- The Commission has established an audit committee as required by Section 4-35-101, *Tennessee Code Annotated* that will work with the Commission staff to periodically review any audit findings and take appropriate effective measures to ensure that the staff recognizes the importance of complying with state policies and procedures.

Museum Response

Museum management is aware that the potential for fraud is more likely to exist when there is not enough separation of fiscal duties. To its detriment, the Museum lost an account technician position in the last round of budget cuts while administrative and fiscal demands have increased tremendously. This resulted in a significant increase in the work responsibilities of the remaining account technician. With its limited number of staff, the Museum has attempted to provide adequate checks and balances, and internal control, and monitoring of fiscal activities by reassigning some of the duties performed by the account technician position that was abolished. During FY 2006/07 budget request period, the Museum was awarded an additional position which will assume some fiscal records management, purchasing and property administration responsibilities. This further segregation of fiscal duties within the Museum should prevent the same individual from performing incompatible functions. The director of administration at the Museum will be responsible for the development and implementation of internal control policies and procedures. These will be presented to the Commission's Executive Director and audit committee for review.

EXPENDITURES

The objectives of the review of the commission's expenditure controls were to determine whether

- policies and procedures regarding expenditures were adequate;
- recorded expenditures were for goods and services that were authorized and received;
- expenditures incurred for goods or services were identified and whether the correct account, budget category, period, and amount were recorded;
- payments were timely;
- commission and museum records were reconciled with Department of Finance and Administration reports;
- contracts were in accordance with regulations;
- contract payments complied with contract terms and purchasing guidelines and were properly approved and recorded;
- all payments for travel have been paid in accordance with the Comprehensive Travel Regulations;
- federal expenditures complied with grant requirements;
- funds encumbered were liquidated for the same purpose as the original encumbrance; and
- deferred revenue transactions are in compliance with applicable state and federal policies and procedures.

To gain an understanding of the commission's procedures and control over expenditures, we interviewed key personnel and reviewed supporting documentation. In addition, testwork was performed on a nonstatistical sample of expenditure transactions during the audit period.

Based on interviews, transaction samples, and review of controls, we determined that expenditures were recorded correctly, goods and services were received, payments were made timely, contract payments complied with contract terms and purchasing guidelines and were properly approved and recorded, sampled payments for travel were paid in accordance with the Comprehensive Travel Regulations, and funds encumbered were liquidated for the same purpose as the original encumbrance.

However, we determined that policies and procedures regarding expenditures are not adequate. The duties of initiating, approving, receiving, and recording expenditures were not properly segregated. In addition, contracts were not in accordance with regulations, and records were not reconciled with Department of Finance and Administration reports; these weaknesses are included in finding 4. We noted that deferred revenue transactions are not in compliance with state and federal policies and procedures as mentioned in finding 3, and federal expenditures did not comply with grant requirements (finding 6). We also determined that goods and services were not purchased in accordance with applicable regulations or requirements as discussed in finding 5.

5. <u>The Tennessee State Museum did not follow purchasing procedures, increasing the risk of inappropriate or unauthorized purchases</u>

Finding

The Tennessee State Museum did not always comply with Department of General Services purchasing procedures when acquiring artifacts and renting exhibitions. Since the museum regularly purchases rare artifacts and rents exhibitions for public display, the need for a single-source purchase is greater for the museum than for most state entities because many of these artifacts and exhibits are unique to one vendor. However, this is not an excuse for circumventing the state's purchasing procedures.

Test work revealed that for two of five single-source purchases tested (40%), the museum paid the vendor through the State of Tennessee Accounting and Reporting System (STARS) without going through the proper purchasing procedures on the Tennessee On-Line Purchasing System (TOPS). Section 16.7 of "General Services Purchasing Procedures" states, "Single-source purchases are made only when an item is unique and possesses specific characteristics that can be filled by one source. These purchases must have proper approval of the Commissioner of General Services."

Based upon inquiries at the Department of General Services, the items also were never charged against the delegated purchase authority (DPA) for that time period. The TOPS manual, Section 21.1, states:

> The purpose of a DPA from Bid is to grant a one-time authority to a department to purchase commodities or services not granted that department by statute.

Both single-source purchases were over $5,000. The TOPS manual, Section 21.5, states:

> In TOPS, there are two processes by which an order can be processed against the DPA for a department through the requisition process and by direct order entry. The requisition process must be used for purchases $5,000 or greater.

Museum management stated that it has made similar purchases of this type on numerous occasions and thought that it was not necessary to follow TOPS policy.

One item was for a specially designed Bridal Couture gown that featured antique laces and machine-made lace collage pieces. The invoice indicated that the gown was commissioned and designed especially for the museum. The gown cost $35,000 and due to the uniqueness of this gown, it could only be purchased from one vendor. The item was originally entered on TOPS but then canceled. The museum's director stated that this item was paid through STARS because the dress was acquired from a traveling exhibit. Therefore, the museum did not have sufficient time to complete the TOPS process before making this purchase.

However, review of the invoice indicated that the invoice was approved on November 12, 2002. A no-cost contract with the vendor had been drafted and approved in September 2002 for the exhibit. Review of this contract indicated that the exhibit was scheduled for November 14, 2002, through January 2003. Since the invoice was approved in September 2002 before the exhibit started, the museum had adequate time to complete the TOPS process.

In addition to these problems, neither the necessary approval for a single-source contract nor a DPA from bid was obtained for the actual purchase of the $35,000 gown.

The other exception noted was the museum's rental of an exhibition from the Knoxville Museum of Art. The total cost of the exhibition was $6,500. Neither a single-source contract nor a DPA was originated for the rental of the exhibit.

In each of these cases, a properly approved personal services contract should have been utilized in place of the TOPS process. Although the majority of the museum's vendors are unique, as compared to vendors typically utilized by other state entities, the state's purchasing procedures should be followed. Not following these procedures could result in the museum's spending more money than the budgeted allotment. Furthermore, it is imperative that each individual within a unit is cognizant of proper internal control procedures associated with their specific job responsibilities. The number and nature of findings noted in this audit are consistent with a weak internal control environment.

Recommendation

The Museum Director should monitor staff to ensure that all purchases are made in compliance with State Purchasing Procedures or through a personal services contract.

The audit committee should carefully consider the nature of this finding and the implications for the commission's control environment and take appropriate effective measures to ensure that all staff of the commission recognizes the importance of complying with state policies and procedures. Top management of the commission should have the experience and judgment to understand the internal and external controls pertinent to the operations of the commission. If staff is in doubt about the applicability of a state procedure to the agency, they should take affirmative steps to ensure they are in compliance with all pertinent requirements.

Management's Comment

We concur. The proper purchasing procedures were not followed.

The management of the Museum fully understands and supports the purchasing regulations and does not foster a work environment that disregards them. The Museum has followed the national and international standard Museum practices that require almost all museum exhibition rentals be secured by a deposit and a contractually agreed upon subsequent payment schedule. The agreement rental with the Knoxville Museum of Art for the *Richard Jolley: Sculptor of Glass* exhibit followed these standards. The Museum's position that while conceding the transaction was not approved via a duly executed personal services contract, it was not a deliberate attempt to circumvent state purchasing policies. Often museum vendors are unique when compared to vendors serving other state agencies, and sometimes cannot conform to the requirements set forth with the regulations. In these cases, the Museum management will work with the Department of General Services and/or the Tennessee State Museum Foundation to find alternative methods to comply with state guidelines while continuing its mandated mission "*……to procure, preserve, exhibit, and interpret objects which relate to the social, political, economic, and cultural history of Tennessee and Tennesseans, and to provide exhibitions and programs for the educational and cultural enrichment of the citizens of the state.*"

Museum staff with procurement responsibilities will attend all training sessions provided by the Department of General Services to learn about new policies and procedures and to ensure the Museum is in compliance with all rules and regulations that promote ethical standards in the purchasing process.

All internal control policies and procedures will be presented to the Commission's Executive Director and audit committee for review.

6. The Tennessee Arts Commission did not ensure that its subrecipient contracts were monitored in compliance with Finance and Administration Policy 22, reflecting a weak internal control environment and increasing the risk that noncompliance with contract provisions could occur and not be detected

Finding

The Tennessee Arts Commission did not submit a subrecipient contract monitoring plan by October 1, 2004, as required by Department of Finance and Administration Policy 22. The monitoring plan and the monitoring performed by the commission also did not comply with Policy 22.

Section 11 of Policy 22, "Subrecipient Contract Monitoring Plan-General Rule," states all state agencies affected by this policy must develop and submit an annual monitoring plan, for review and approval, to the Department of Finance and Administration, Division of Resource Development and Support, by October 1st of each year, beginning in 2004.

During the week of May 2, 2005, the auditor requested to review the commission's subrecipient contract monitoring plan. According to the Executive Director, at the time of request, a plan had not been submitted by the commission. On May 9, 2005, seven months after the due date, the Executive Director submitted a subrecipient monitoring plan to the Office of Program Accountability Review. However, the plan submitted did not meet the requirements set forth in Section 12 of Policy 22 because the plan did not include the total subrecipient contract population, the identification of the agency monitoring cycle, full-time equivalents and personnel classifications for all staff dedicated to monitoring activities, a program description of each state and/or federal program being monitored, risk assignment for each subrecipient and its related contract(s), a summary of findings from the previous monitoring year, or an explanation of the agency's corrective action process.

The next month, on June 7, 2005, the Executive Director submitted a "Subrecipient Monitoring Summary" to the Department of Finance and Administration detailing monitoring activity for the fiscal year ended June 30, 2005. The summary indicates that the commission awarded 441 subrecipient grant contracts totaling $4,857,120. According to the Executive Director, from the 441 awards, the commission selected 246 designated major arts program subrecipient grant contracts and performed desk audits. As noted by the plan, desk audits were used to determine a risk level for each selected contract. The Executive Director stated that the desk audits were conducted between April 18, 2005, and May 13, 2005. However, the summary notes that some desk audits were not completed until June 2005.

As indicated on the desk audit form, in order to assess risk levels, five questions must be answered by the commission personnel reviewing the contract. Two of the five inquiries deal with the pre-award conditions of the contract, two inquiries addresses significant staff turnover and existence of major findings in the subrecipient's last audit, and the final inquiry instructs the reviewer to note any other reason an on-site monitoring visit is needed. Risk levels are assigned according to the number of the above criteria the contract meets. Risk is high if three or more criteria are met, medium if two criteria are met, and low if one or none of the criteria are met. While testwork on a sample of 25 low/medium-risk desk audits indicated that the forms were completed, no documentation was provided to support the low/medium-risk determination made by the commission. According to the Executive Director and the desk audit format, only subrecipient contracts that were assessed as high-risk had on-site monitoring visits or technical assistance. Only 6 of the 246 subrecipient contracts selected were considered high-risk. A synopsis of the data in the monitoring summary is noted in the table below.

Risk Level: Activity Taken	**Contract Risk Assessments**		**Contract Monitoring Activities**	
	Number	**Percentage**	**Number**	**Percentage**
Low to Medium: Desk reviews	240	54.4%	0	0%
High: On-site monitoring	6	1.2%	6	1.4%
Not Assessed: Not Monitored	195	44.4%	435	98.6%
Total Awards	441	100%	441	100%

Policy 22 requires agencies to complete risk assessments for all subrecipients and their related contract(s). The monitoring summary indicates that risk assessments were conducted for only 246 of the 441 subrecipient contracts awarded for fiscal year end 2005.

Policy 22 provides the following definition of monitoring:

> Monitoring is the review process used to determine a subrecipient's compliance with the requirements of a state and/or federal program, applicable laws and regulations, and stated results and outcomes. Monitoring also includes the review of internal controls to determine if the financial management and the accounting system are adequate to account for program funds in accordance with state and/or federal requirements. Monitoring should result in the identification of areas of non-compliance with the expectation that corrective action will be taken to ensure compliance.

Additionally, Policy 22 states that all monitoring activities undertaken by any state agency should address the applicable core monitoring areas, as defined by the OMB Circular No. A-133 Compliance Supplement.

The commission requires its employees to prepare an on-site monitoring report, which was created by the commission and included in the commission's monitoring plan, in order to conduct on-site visits. However, the on-site monitoring report only requires commission personnel to obtain general information. The form requires the name of the subrecipient; location of the visit; date; city/town; who the visit was with; the commission employees who conducted the visit; whether the topic covered was programmatic, fiscal, or other and an explanation; and finally, concerns and recommendations. The on-site monitoring report format does not address the core monitoring areas as defined by OMB Circular No. A-133, nor does it meet the requirements of monitoring as defined in Policy 22.

Test work performed on the six subrecipient contracts determined to be high-risk revealed that in fact none of six on-site monitoring reports (100%) were prepared and documentation did not exist to indicate that monitoring was performed. The commission hired outside consultants to render technical assistance, reorganize, reshape, and provide other consulting services to three of the six high-risk subrecipient contracts. Based on discussions with the Executive Director, the work performed by the consultants was deemed monitoring by the commission. The commission used reports prepared by the consultants in place of the monitoring report. However, based on the definition of monitoring and the requirements set forth in Policy 22, consultant work is not adequate monitoring and commission personnel should have monitored the agencies as required by Policy 22. According to the Executive Director, monitoring was not conducted for the remaining three because serious problems were noted for the subrecipients during the pre-award review phase. Therefore, the commission board decreased the level of funding for the contracts and placed stipulations on receipt of the funding. Testwork also revealed that desk audits, used to determine risk, were in fact not conducted on two of the six high-risk subrecipient contracts (33%). For another two of the six (33%), the risk level noted on the desk audit did not agree to the risk level reported in the monitoring summary.

Section 13 of Policy 22, "State Monitoring Requirements," notes that each year two main criteria must be met when selecting the population of contracts to be monitored:

- agencies must annually monitor a minimum of one-third of the total number of all subrecipient contracts executed by their agency, and
- the aggregate current-year maximum liability value of the contracts selected must be equal to or greater than two-thirds of the aggregate current-year maximum liability value of the agency's entire subrecipient grant population.

The commission failed to meet the one-third minimum monitoring requirement or the two-thirds-or-greater maximum liability value requirement. The table below includes the data as provided by the monitoring summary.

	A	B	C	D	E
	Total Contract Awards	**Actual On-site Monitoring**	**1/3 & 2/3 Monitoring Required by Policy 22**	(C-B) **Unmet Requirements**	(D/C) **% of Requirements Unmet**
Number	441	0	147	147	100%
Dollar Value	$4,857,120	$0	$3,254,270	$3,254,270	100%

Inadequate risk assessments and monitoring by the Tennessee Arts Commission could result in the failure to detect misuse of state and federal funds by subrecipient organizations.

Recommendation

The Executive Director of the Arts Commission should develop a subrecipient contract monitoring plan that addresses all the areas of Policy 22, and the Executive Director should ensure that the monitoring plan is submitted by October 1 of each year. The Executive Director should also ensure that adequate risk assessments are performed on all subrecipient contracts, that monitoring is performed on one-third of the total subrecipient grant contracts awarded each applicable year, that the aggregate current-year maximum liability value of the contracts selected for monitoring is equal to or greater than two-thirds of the aggregate current-year maximum liability value of the entire subrecipient population, and that the core monitoring requirements of OMB Circular A-133 are met when contracts are monitored.

Management should ensure that risks such as these noted in this finding are adequately identified and assessed in their documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. Management should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

The audit committee should carefully consider the nature of this finding and the implications for the commission's control environment and take appropriate effective measures to ensure that all staff of the commission recognize the importance of complying with state policies and procedures. Top management of the commission should provide a clear message to all staff of the importance of compliance with state policies and procedures. If staff is in doubt about the applicability of a state procedure to the agency, they should take affirmative steps to ensure they are in compliance with all pertinent requirements.

Management's Comment

We concur. The Tennessee Arts Commission did not submit a sub-recipient contract monitoring plan by October 1, 2004, as required by the Department of Finance and Administration Policy 22. The monitoring plan and the monitoring performed by the Commission did not comply adequately with Policy 22.

Contract accountability and grant monitoring is an administrative services function and the former director of administrative services was the designated compliance officer for grant monitoring and the immediate supervisor of the grants management director. Furthermore, the responsibility includes systematic reporting to the Executive Director as the appointing authority. Prior to Fiscal Year 2005, the agency contracted with the Department of Finance and Administration to perform Par Monitoring after risk levels were assigned to all grantees by the agency. With the implementation of Department of Finance and Administration Policy 22 Sub-recipient Contract Monitoring, the responsibility was returned to state departments or agencies. The former director of administrative services was designated as the Commission's Policy 22 compliance officer and all communications from the Senior Management Analyst of the Department of Finance and Administration's Office of Audit and Consulting Services to the Tennessee Arts Commission was directed to this staff member.

On March 15, 2005, after 28 years and 4 months of state service, the Commission's former Director of Administrative Services announced her retirement, effective March 31, 2005. She agreed to a 100 day contract covering the next five months to train her replacement and to work with the auditors (as she had done on all previous Commission audits). On March 24, 2005, the agency was notified of the first meeting with the auditors from the State Comptroller's office to discuss the forthcoming three year audit. In an electronic mail sent to the Executive Director, dated 5:11:20 PM, March 30, 2005, the former Director of Administrative Services said, "Today is my last day and I will not be here tomorrow." She further stated that she would not return to work and honor the 100 day contract.

When the auditor requested a meeting to review the Commission's sub-recipient contract monitoring plan the week of May 2, the Executive Director informed her that the communication outlining the requirements of Policy 22 to establish a sub-recipient contract monitoring plan had never been shared with him. He explained that that the agency did monitor grantees in a variety of ways, but that he could find no record that the required plan had been submitted. The Executive Director immediately contacted Senior Management of the Office of Audit and Consulting Services to understand requirements and implement procedures to bring the agency in compliance with Policy 22. The Executive Director was familiar with previous monitoring procedures and used those to initiate the monitoring process. These included the use of desk audits, site-visits, and peer advisory panel recommendations to monitor grants and assign risk levels. It was not the intent of the Executive Director or staff to mislead the auditor about the existence of a monitoring plan, but to demonstrate a best faith effort to try and meet the requirements of Policy 22.

The Commission has established an audit committee as required by Section 4-35-101, *Tennessee Code Annotated* that will work with the Commission staff to review any audit findings and take appropriate effective measures to ensure that all staff recognizes the importance of complying with state policies and procedures.

The Executive Director has already implemented procedures to address the finding and will ensure that adequate risk assessments are performed on all sub-recipient contracts. These include:

- To ensure that information flows both up and down, the Executive Director will be provided with a copy by staff of all communications requiring compliance with Policy 22.

- On June 16, 2005, new staff was employed in a grants analyst position with the responsibility for the development and implementation of the agency's sub-recipient contract monitoring plan to ensure the agency's compliance with Policy 22.

- On September 29, 2005, the Commission submitted a sub-recipient contract monitoring plan for Fiscal Year 2006. On November 22, 2005, the Executive Director and designated staff met with representatives from the Office of Audit and Consulting Services to review the Commission's submitted sub-recipient contract monitoring plan for Fiscal Year 2006. Immediately after that meeting, the agency's plan was approved.

DEPARTMENT OF FINANCE AND ADMINISTRATION POLICY 20 – "RECORDING OF FEDERAL GRANT EXPENDITURES AND REVENUES"

Department of Finance and Administration Policy 20 requires that the state departments whose financial records are maintained on the State of Tennessee Accounting and Reporting System (STARS) fully utilize the STARS grant module to record the receipt and expenditure of all federal funds. Our objectives were to determine whether

- appropriate grant information was entered into the STARS Grant Control Table upon notification of the grant award, and related revenue and expenditure transactions were coded with the proper grant codes;
- the commission utilized the appropriate STARS reports as the basis for preparing the Schedule of Expenditures of Federal Awards;
- the commission did not hold the Daily Grant Drawdown Reports for more than 30 calendar days;
- all grant award amounts were recorded in the STARS Grant File; and

- the commission utilized the Labor Distribution System (LDS) to redistribute payroll expenditures.

We interviewed key personnel to obtain an understanding of the department's procedures and controls concerning Policy 20. The STARS Grant Control Table and other supporting documentation were reviewed.

We determined that the commission did not comply with Policy 20. The commission did not use the STARS Grant Control Tables upon notification of the grant award, the Daily Grant Drawdown Reports were held for more than 30 calendar days, and all grant award amounts were not recorded in the STARS Grant File. The commission also could not provide support in order to determine whether the appropriate STARS reports were utilized as the basis for preparing the Schedule of Expenditures of Federal Awards.

7. **For the sixth consecutive audit, the commission did not mitigate the risk of inadequate recording of federal grants expenditures and revenues and failing to draw down federal funds on a timely basis in compliance with Finance and Administration Policy 20**

Finding

For the sixth consecutive audit, the Tennessee Arts Commission did not comply with the Department of Finance and Administration's Policy 20, "Recording of Federal Grants Expenditures and Revenues."

Management has concurred with all of the prior five audit findings. The previous audit's recommendation stated, "The Executive Director should determine why no action has been taken to ensure drawdowns comply with the Department of Finance and Administration's Policy 20, or request an exemption." The Executive Director's comments in the previous audit stated,

> The Executive Director has met with the appropriate staff member to resolve this repeated finding. As a small agency with limited administrative staff, that is not only responsible for financial and personnel procedures of the Commission, but also the State Museum, the failure to draw down federal funds has been a matter of an exhaustive workload and time limitation. The Director of Administrative Services has discussed this repeated finding with the Department of Finance and Administration to assist with an exemption if necessary to comply with Policy 20 or develop a policy to eliminate future findings.

However, according to Department of Finance and Administration personnel, no exemption request was made to, or approved by, the Department of Finance and Administration. Also, discussion with commission personnel indicates that no policy was developed to eliminate future findings. According to the Executive Director, the former Director of Administrative Services was instructed to develop procedures and take measures to comply with the policy; and had reported to him that the commission was in compliance. However, the Executive Director failed to ensure that compliance was actually achieved. It was not until the former Director of Administrative Services retired, that the Executive Director determined that the commission not only had failed to comply with the policy, but also had not made timely drawdowns of federal funds.

During the audit period, the commission received eight grants from the National Endowment for the Arts. Of those eight grants, four were not added into the State of Tennessee Accounting and Reporting System (STARS) Grant Control Table. The Grant Control Table contains pertinent information related to each grant (i.e., federal funding percentage, maintenance of effort, federal grant name and number, etc.). Policy 20 requires all agencies that receive federal funds as a grantee or subgrantee enter the data for each grant into the STARS Grant Control Table. Once the grant information has been entered, the Grant Control Table identifies each grant with a grant/subgrant code, assigned by the Department of Finance and Administration. Each grant must be established in the Grant Control Table before the grant code can be used in STARS. In addition, for all eight grants, the commission staff failed to record the grant award amounts by the end of the month in which the grant award notification was received. Policy 20 states, "All grant award amounts must be recorded in the STARS Grant File. The amounts should be recorded no later than the end of the month in which the grant award notification is received from the Federal government." Furthermore, the *State of Tennessee Administrative Manual*, Chapter 4, Grant Accounting, Section 5A, Recording the Grant Award, states, "Grant awards should be recorded on a reallocation journal voucher, Batch Type H." The commission's H-type journal vouchers were reviewed, and based on the review performed, it did not appear the commission had used this type of journal voucher to record the grant award. In fact, commission personnel admitted to the auditors that they did not even know how to record the grants in the grant file.

Policy 20 also states that "no Daily Grant Drawdown Report will be held for more than 30 calendar days." However, the former Director of Administrative Services did not make monthly drawdowns of federal funds as required by Policy 20. For several grants, the former Director of Administrative Services only made one drawdown request after the grant period. According to the Executive Director and review of documentation submitted to the National Endowment for the Arts (NEA), the former Director of Administrative Services did not make the drawdowns timely, and after the time period had lapsed, the Executive Director made special requests to NEA in order to receive the monies.

There were other Policy 20 requirements that could not be tested and/or verified because commission employees did not know if the procedures had been performed. Policy 20 states, "Agencies must utilize the STARS 'Schedule of Grant Activity' Report as the basis for preparing the Schedule of Expenditures of Federal Awards." Also, Policy 20 states, "Status reports to the Federal government must be prepared utilizing STARS, including the grants module, as the basis with any reconciling items documented." It could not be determined if these requirements were met because, according to commission employees, Policy 20 compliance was the responsibility of the former Director of Administrative Services, and this employee's work could not be confirmed by current employees.

Recommendation

The chairman of the commission should reread the past five audit findings related to this condition, including the recommendations and management's comments. Top management must be able to assign duties to staff and have an expectation those assignments will be completed in accordance with instructions. However, the fact that this condition had existed, been reported to management, and not been corrected by staff numerous times, should have indicated the need for additional oversight by the Executive Director to ensure its successful resolution.

The Executive Director of the commission should develop and implement policies and procedures to ensure the commission complies with all requirements of the Department of Finance and Administration's Policy 20. These procedures should ensure that all required grant information is keyed into the STARS Grant Control Table and recorded in the STARS Grant File in accordance with Policy 20. In addition, the procedures should ensure that the drawdown of federal funds is made, at least on a monthly basis or in compliance with the grantor's requirements. Furthermore, these procedures should ensure that STARS reports are the basis for preparing both the Schedule of Expenditures of Federal Awards and the status reports that are submitted to the federal government.

The commission chairman should ensure that risks such as these noted in this finding are adequately identified and assessed in management's documented risk assessment activities. The Executive Director should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. The Executive Director should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

Management's Comment

We concur. The Tennessee Arts Commission did not comply with Department of Finance and Administration Policy 20, "Recording of Federal Grants and Expenditures and Revenues."

Immediately after the Audit Report for the Years Ended June 30, 2001, and June 30, 2000, the Executive Director met with the former Director of Administrative Services and expressed his displeasure of this repeated audit finding. The employee told the Executive Director this repeated finding was the result of an exhaustive workload due to limited staff within a small agency and because the federal fiscal year (October-September), in which grants were awarded, and the state fiscal year (July-June), were not the same and had created a reporting problem. The employee said she had discussed a possible exemption from Policy 20 with officials in the Department of Finance and Administration, but they advised against such an exemption.

The former Director of Administrative Services was instructed to immediately begin a drawdown of federal funds to bring the agency in compliance with Policy 20. During the audit period, the former Director of Administrative Services reported to the Executive Director and the

Commission at quarterly meetings when the audit was reviewed, that the agency was in compliance with Policy 20. On March 18, 2005, when the Executive Director was presenting the Commission's Fiscal Year 2006 Budget Request before the Senate Finance Committee, the former director of administrative services was in attendance and reported the agency was in compliance with Policy 20 when questioned by a state senator about the repeated audit finding. During the audit period, the Executive Director inquired of staff of the National Endowment for the Arts' State Partnership Agreement Program about the Commission's compliance with Policy 20. He was assured by the NEA that the agency was in compliance with Policy 20.

When the Executive Director received the March 30, 2005, electronic mail from the former Director of Administrative Services announcing her decision not to return to the Commission, it also included, "I'm sorry I did not get all federal reports completed." Suspecting he and the Commission had been given incorrect information, the Executive Director immediately called the National Endowment for the Arts to inquire about the status of grant awards to the Commission. The Executive Director was informed for the first time that, not only had the agency failed to draw down federal dollars in Fiscal Year 2005 ($613,500), but the agency also failed to draw down federal dollars in Fiscal Year 2004 ($589,800). He reported this immediately to the Chair of the Commission.

The Executive Director met with personnel in the Department of Finance and Administration to get an understanding of how the agency could close out a fiscal year without drawing down federal dollars. He began immediately to implement policies where this could not occur in the future.

With the assistance and understanding of the State Partnership Agreement Program and the Office of Grants at the National Endowment for the Arts, the Executive Director was able to draw down $1.1 million federal funds (FY2004 and FY2005) within two weeks and the remaining balance of $98,825 (FY2005) was drawn down in August 2005.

On April 21, 2005, the Executive Director was asked to appear before the Fiscal Review Committee to explain the failure of the agency to comply with Policy 20 and the repeated audit findings. The Executive Director presented documentation to the Fiscal Review Committee that explained the problems created by the former director of administrative services and outlined policies he had put in place to bring the agency in compliance. The committee was understanding and complimented the agency's efforts.

Former Chairs, during this audit period, and the current Chair of the Commission received a detailed explanation of the circumstances surrounding this finding. The Executive Director is a 24 year employee with the Tennessee Arts Commission and works diligently to employ a staff of qualified individuals to carry out the to work of the agency. Individuals are recruited, employed, trained and expected to perform their assigned responsibilities. Unfortunately, sometimes employees fail to perform responsibly or honestly. The Commission is as disappointed by the actions of the former employee as is the Executive Director. Everyone feels betrayed. The Chair of the Commission does not question the integrity or the ability of the Executive Director to understand the regulatory environment in which the Commission operates.

The Commission has recently established an audit committee as required by Section 4-35-101, *Tennessee Code Annotated*, that will work with the staff to periodically review any audit findings and take appropriate effective measures to ensure that all staff recognizes the importance of complying with state policies and procedures.

The Executive Director has implemented policies and procedures to ensure that the Commission is in compliance with all requirements of the Department of Finance and Administration Policy 20. These include:

- To ensure that information flows both up and down, the Executive Director will be provided with a copy by staff of all communications requiring compliance with Policy 20.
- The Executive Director has worked with the Department of Finance and Administration to establish multiple cost centers. Previously, the agency operated out of one cost center. Cost centers now correspond with budget allotment codes and various grant categories that are on the grant control table.
- A qualified information technology director has been employed and has created a program that will allow the agency's PEARL Grant Management System to be keyed in the STARS Grant Control Table and recorded in the STARS Grant File in accordance with Policy 20 for payment. These procedures ensure that STARS reports and status reports are submitted in a format required by the National Endowment for the Arts.
- A ten-year career state employee with a strong background and experience in accounting has been employed to fill the administrative services director position. He is responsible for the agency's compliance with Policy 20, including the design and implementation of internal controls; monitoring of compliance with all state administrative policies and procedures; and the development and monitoring of the Commission's budget and approval of all grant payments. The administrative services director will work with the agency's account technician, grants management director and grants analyst in carrying out these responsibilities.

VEHICLE REGISTRATION REVENUE

The objectives of the review of the commission's vehicle registration revenue were to determine whether

- policies and procedures regarding vehicle registration revenue were adequate, and
- designated funds from the sale of vehicle registration plates are properly accounted for and used in compliance with applicable state policies.

Based on interviews and review of supporting documents, we determined that the commission does not have policies and procedures in place to ensure compliance with state law regarding vehicle registration revenue.

8. <u>As noted in the prior audit, the commission does not have internal controls over the accounting and expenditure of funds from the sale of new specialty earmarked vehicle registration plates</u>

Finding

As noted in the prior audit, the Tennessee Arts Commission still does not have an internal control system in place to ensure funds from the sale of new specialty earmarked vehicle registration plates are allocated in accordance with state law. The commission is allocated revenue from the sale of various types of vehicle registration plates by the Department of Revenue. Section 55-4-215, *Tennessee Code Annotated*, prescribes the following requirements for the distribution of new specialty earmarked motor vehicle registration plate revenue:

> The revenues allocated to the arts commission . . . shall be distributed by the arts commission in the form of grants to arts organizations of events which meet criteria established by the arts commission for receiving grants, within the following parameters: (1) One third (1/3) of such funds shall be distributed to qualifying arts organizations or events in urban counties; and (2) Two thirds (2/3) of such funds shall be distributed to qualifying arts organizations or events in rural counties.

There was still no documentation present to determine whether the commission's staff had ever made the calculations necessary to ensure that urban counties receive one-third and rural counties receive two-thirds of the funds collected from the sale of specialty plates. Furthermore, commission management developed no policies or procedures to assess, control, or document its distribution of the specialty plate funds. The Executive Director stated that based on the total number of grant payments made to urban and rural grantees, he felt the commission would always easily be in compliance. However, assuming that compliance is met is not an adequate control to mitigate the risk of noncompliance.

The Executive Director stated that a comparison could be made between the amount required for compliance and the total shown as funded in the PEARL system, which is the commission's grant system. However, actual grant payments are not recorded in PEARL but are recorded in STARS. The amount funded according to PEARL represents the amount originally agreed to in the grant contract. The amount funded to subrecipients can vary from the amount the commission actually distributed. Examples of these differences were noted during testwork performed by the auditor. Also, many of the grant payments made involve partial or 100% federal funding.

Although management demonstrated that there were procedures that could be performed which would support compliance with the law, there was no evidence that the commission had performed these procedures as a means of control and determination as to whether compliance had actually been achieved. It was only after the auditors performed subsequent comparisons of revenues from the new specialty earmarked vehicle registration plates with the amounts actually distributed to the subrecipients that compliance with the law was actually documented.

Since a control was not in place to determine the actual amount distributed to subrecipients, the commission does not know at all times if it is in compliance with Section 55-4-215, *Tennessee Code Annotated*.

Recommendation

The commission should implement an internal control system to ensure compliance with Section 55-4-215, *Tennessee Code Annotated*. This system should involve comparing the revenues from the sale of new specialty earmarked vehicle registration plates with the payments made to urban and rural grantees, ensuring that those revenues are distributed in accordance with state law. Furthermore, the control system should adequately segregate payments that are made using state funding from payments made using federal funding.

The commission chairman should ensure that risks such as these noted in this finding are adequately identified and assessed in management's documented risk assessment activities. The Executive Director should identify specific staff to be responsible for the design and implementation of internal controls to prevent and detect exceptions timely. The Executive Director should also identify staff to be responsible for ongoing monitoring for compliance with all requirements and taking prompt action should exceptions occur.

Management's Comment

We do not concur. As noted in the prior audit, revenue from the sale of specialty license plates was reported to the Commission by the Department of Revenue as a lump sum and the sale of "new specialty earmarked vehicle registration plates" could not be determined. Therefore, it was impossible for the Commission to allocate revenue according to Section 55-4-215, *Tennessee Code Annotated*, within the parameters: (1) One third (1/3) of such funds shall be distributed to qualifying arts organizations or events in urban counties; and (2) Two thirds (2/3) of such funds shall be distributed to qualifying arts organizations or events in rural areas, because revenue was not reported to the Commission in this manner.

Beginning in Fiscal Year 2003, the Department of Revenue instituted a new procedure of reporting the sale of specialty license plates to the Commission in three different categories; (1) Olympic Plates; (2) New Specialty Earmarked Plates (that gives the Commission 40% from sale of the plate); and (3) All Other Specialty Plates (that includes Collegiate/ University, Personalized and Others).

The Executive Director fully understands the basic operation of the agency's grant system. The Executive Director attempted to explain to the auditors how the Commission can and does track the allocation of the new specialty earmarked vehicle license plates as required by Section 55-4-215, *Tennessee Code Annotated.* All grant applications can be tracked by county (rural or urban) and the amount they are requesting when entered into the Commission's PEARL Grant Management System. The agency can track amounts going into respective counties (rural or urban) when the staff prepares allocation recommendations to the Commission to ensure compliance with Section 55-5-215, *Tennessee Code Annotated*. A third opportunity to track compliance is at the time when grant awards are decided by the Commission, whether the grant award is going into a rural or urban county. A fourth way to track compliance is by reviewing payment requests from the grantee by county, fifth way to track is when the grantee is paid in full in STARS and the contract is closed out.

Using Fiscal Year 2004 as an example, revenue figures provided by the Department of Revenue for new specialty earmarked vehicle registration plates show $618,594 available to be allocated by the Commission. One third (1/3) or $138,054 should be allocated in urban counties and two-thirds (2/3) or $480,540 should be allocated to rural counties. The Executive Director demonstrated to the auditor by examining copies of request for payment files arranged alphabetically and by grant awards, then comparing the grant amount awarded to organizations by county (urban or rural), it can be documented that the Commission is in compliance of the one third, two third allocations required by Section 55-4-215, and therefore an internal control is in place. The Executive Director pointed out that the bottom line final grant close-out amount may not be the same as the grant award amount awarded because all grants do not close out at the amount awarded, but the difference will be a small amount compared with the total awarded. For instance, in Fiscal Year 2004, total grant awards to rural counties in Tennessee totaled $554,045.00 and closed out at $553,104.80, a difference of $940.20.

The Commission has established an audit committee as required by Section 4-35-101, *Tennessee Code Annotated*, that will work with Commission staff to review any audit findings and take appropriate effective measures to ensure that all staff recognizes the importance of complying with state policies and procedures.

In order to address this finding the agency has developed internal control procedures to better track new specialty earmarked vehicle registration plates, to ensure compliance with Section 55-4-215, *Tennessee Code Annotated*. These include:

- Establishment of cost centers, with two of these centers designated for grant awards funded from the sale of new specialty earmarked registration plates (rural or urban).
- The director of administrative services has been assigned responsibility of designing, implementing and monitoring internal controls to identify risk assessment activities for the agency and to recommend action that may need to be taken by the appointing authority.

Rebuttal

Although there may have been ways for management to track awards between rural and urban counties, there was still no documentation present to determine whether the commission's staff had ever made the calculations necessary to ensure that urban counties receive one-third and rural counties receive two-thirds of the funds collected from the sale of specialty plates. Compliance alone does not ensure that management maintained sufficient internal controls to ensure such compliance. Furthermore, the commission's PEARL system did not identify the funding sources for the grant awards. If revenue other than specialty plate revenue had been used to fund a significant portion of rural awards, the commission could have failed to comply with the law.

CONFLICTS OF INTEREST

The objectives of our review of the conflict-of-interest policies and procedures were to determine whether

- the commission has established comprehensive, written conflict-of-interest policies and procedures for management and staff employees,
- signed conflict-of-interest disclosure forms were on file, and
- annual certifications were completed and submitted according to Executive Order No. 3.

We interviewed key personnel to gain an understanding of policies and procedures regarding conflicts of interest. We randomly selected personnel files to determine if conflict-of-interest disclosure forms were completed.

Based on our testwork, we determined that the commission does not have a conflict-of-interest policy for its employees and employees were not required to submit conflict-of-interest disclosure forms. We also determined that the commission did not comply with Executive Order No. 3 and did not complete or submit annual certifications to the Governor's Legal Office as discussed in finding 9.

9. The Executive Director did not provide any guidance to employees of the Tennessee Arts Commission and the Tennessee State Museum regarding conflicts of interests responsibilities and failed to ensure the entities were in compliance with state law and the Governor's Executive Order on Ethics and Conflicts of Interest

Finding

The Executive Director of the Tennessee Arts Commission failed to instruct employees of the commission or museum to complete Department of Finance and Administration ethics policy receipt statements as required by Executive Order No. 3. Also, annual certifications were not completed and submitted to the Governor's Legal Office by January 31, 2004, or January 31, 2005, as required. Executive Order No. 3 states,

> 9. …The Compliance officer shall inform each employee within his or her department of the requirements of this Order and shall distribute the Order to each employee. The Compliance Officer shall obtain from each employee a signed statement, using a form prepared by the Commissioner of Finance and Administration, that the employee has received a copy of

this Order, has read it, and agrees to abide by its terms as a condition of employment.

10. Annual Certification. On or before January 31 of each year, the head of each department shall submit a written statement to the Governor, in a form prepared by the Commissioner of Finance and Administration, stating that all material violations of this Order known to the head or to the Compliance Office have been reported to the Ethics Committee…

The Executive Director failed to establish a written policy addressing conflict-of-interest disclosures for the Commission and Museum. As a result, the entities failed to comply with Sections 12-4-101, 12-3-106, and 8-50-501 through 506, *Tennessee Code Annotated*, concerning interest in state contracts, acceptance of gifts, and financial disclosure, respectively. During the period under review, employees in authority at the commission and museum were neither distributed disclosure forms to complete nor required to make disclosures of existing conflicts of interest. Directors, supervisors, and other employees with authority are required to submit disclosure statements in accordance with Section 8-50-506(c), *Tennessee Code Annotated*:

> Disclosures provided for in this section shall apply to any employee or person whose duties are to regulate, inspect, audit or procure goods or services or to administer tax laws. Disclosures are required for individuals who have authority over these persons or these functions.

The auditor discussed with the Executive Director on April 14, 2005, the noncompliance concerning Executive Order No. 3 and the *Tennessee Code Annotated* requirements. On April 19, 2005, the Executive Director presented policy acknowledgement forms, dated April 18, 2005, which each employee signed acknowledging receipt of various *Tennessee Code Annotated* laws. However, the Executive Director failed to have employees complete the Department of Finance and Administration ethics policy and gift acceptance forms, as required by Executive Order No. 3. Also, disclosure statements listing all existing conflicts were not completed as required by Section 8-50-502, *Tennessee Code Annotated*, and the 2005 annual certification was not completed and submitted to the Governor's legal office until May 17, 2005, four months after the deadline.

Conflict-of-interest disclosures and Executive Order No. 3 forms are designed to ensure that the public's interest is protected and those who make key decisions about business operations are independent from the other parties involved. Written disclosures about financial interests, prior employment, employment of immediate family members, and other matters that may influence decisions help to ensure that the commission and museum are acting on the state's behalf and that employees recuse themselves from decision making as needed.

Recommendation

The Executive Director of the Tennessee Arts Commission should establish written conflict-of-interest policies to ensure compliance with Sections 12-4-101, 12-3-106, and 8-50-501 through 506, *Tennessee Code Annotated.* Policies should require employees to sign and update as necessary annual disclosure forms addressing direct or indirect interest in any business, government, or organization the commission or museum contracts with or deals with during the course of its activities. The Executive Director should also comply with Executive Order No. 3 by ensuring that all employees complete, submit, and annually update required forms and that annual certifications are submitted by submission deadlines. In order to mitigate the risk of noncompliance in the future, it is imperative that the Executive Director take a much more proactive posture regarding the commission's compliance with these matters. Furthermore, the commission members should consider their responsibilities for ensuring the existence of a positive internal control environment as they review management's documented risk assessment activities.

Management's Comment

We concur. The Executive Director takes seriously conflicts of interest responsibilities and ensuring compliance with state law and the Governor's Executive Order on Ethics and Conflicts of Interest. However, the Executive Director depended on the agency's compliance officer, the former director of administrative services, to keep him and management of the State Museum informed of state requirements when communication was received by the agency.

When the auditor brought to the attention of the Executive Director that the Commission and State Museum were not in compliance with state law and the Governor's Executive Order on Ethics and Conflict of Interest, he acted responsibly and expeditiously to bring the Commission and the State Museum into compliance. This included distributing copies of Executive Orders 1, 2, and 3, along with a discussion of these orders with the Commission staff. Sign off forms were distributed, completed, and placed in each employee's personnel file. The Executive Director addressed the same with the management of the State Museum.

The Executive Director contacted legal counsel to the Governor for clarification of the Governor's Executive Orders to ensure all Commission and State Museum employees completed the required forms. The Commission agrees with the audit finding that required completed and signed disclosure forms were not submitted by the required date. The Executive Director takes exception with the auditor's assertion that he did not act in an expeditious manner when this was brought to his attention.

The Commission has established an audit committee as required by Section 43-5-101, *Tennessee Code Annotated*, that will work with the Commission and State Museum staff to review any audit findings and take appropriate effective measures to ensure that all staff recognizes the importance of complying with state policies and procedures.

The Executive Director has implemented procedures to ensure that the Commission and State Museum are in compliance with state law and the Governor's Executive Orders on Ethics and Conflicts of Interest that include:

- To ensure that information flows up and down, the Executive Director will be provided with a copy by staff of all communications requiring compliance with state law and Governor's Executive Order on Ethics and Conflicts of Interests.
- The director of administrative services has been designated as the agency's compliance officer and will keep the Executive Director informed and will submit all required documents in a timely manner.
- On or before the beginning of each new fiscal year, the compliance officer will distribute Executive Orders on Ethics and Conflicts of Interest to employees and after review of these documents, will obtain from each employee a signed statement that the employee has received a copy of the Order, has read it, and agrees to abide by its terms as a condition of employment.
- On or before January 31 of each year the compliance officer will prepare a written statement from the Executive Director to be submitted to the Governor listing all material violations that have been reported to the Ethics Committee.
- New employees will be advised of the Executive Orders on Ethics Conflicts of Interest and information including all required documents to be completed by employees will be included in their orientation material.

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 Tennessee Art Commission'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 Tennessee Arts Commission'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 commission's procedures. We also requested 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 were not submitted by the deadlines and an evaluation of internal accounting and administrative control was not performed in order to support the internal accounting and administrative control evaluation report submitted. Corrective actions have not been taken on the weaknesses noted. See finding 10.

10. <u>As noted in the prior audit, the commission did not comply with the Financial Integrity Act</u>

Finding

As noted in the prior audit, the Tennessee Arts Commission did not comply with the Financial Integrity Act by preparing or submitting responsibility letters acknowledging responsibility for maintaining the internal control of the commission by June 30, 2002; June 30, 2003; and June 30, 2004.

Management concurred with the prior audit finding and stated, "The executive director will issue a directive to the appropriate staff to ensure the report will be completed and submitted December 31, 2002. We will monitor the procedure." However, the Executive Director did not adequately monitor the staff to ensure that compliance was actually achieved. It was not until the former director of Administrative Services retired that the Executive Director learned that the commission had not only failed to submit the above-mentioned reports, but also had not maintained support for the reports issued during the audit period.

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 of the commission, to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30, 1999, and each year thereafter. In addition, the head of each executive commission is also required to conduct an evaluation of the commission's internal accounting and administrative controls and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

The commission submitted Financial Integrity Evaluation Reports December 28, 2004; December 31, 2003; and December 31, 2002. However, the commission could not provide documentation of actual evaluations, of internal accounting and administrative controls, performed in support of the reports submitted each applicable year. Therefore, the December 31, 2003 Financial Integrity Report on the evaluation of internal accounting and administrative controls was not in compliance with *Tennessee Code Annotated*.

Recommendation

The commission chairman should ensure the required Financial Integrity letters and reports are submitted to the Commissioner of Finance and Administration and the Comptroller of the Treasury by the submission deadlines. The Executive Director should also ensure that evaluations of internal accounting and administrative controls are performed and documented before Financial Integrity Evaluation Reports are submitted.

Management's Comment

We concur. The Commission did not comply with the Financial Integrity Act by submitting a letter acknowledging responsibility for maintaining the internal control of the agency.

Immediately after receiving the finding in the previous Audit Report, the Executive Director met with the former director of administrative services regarding her responsibility and the audit finding. She reported it was an oversight on her part and promised the Executive Director and the Commission this would not happen again.

The Commission has established an audit committee as required by Section 4-35-101, *Tennessee Code Annotated*, that will work with the Commission and Museum staff to review any audit findings and take appropriate effective measures to ensure that all staff recognizes the importance of complying with state policies and procedures.

The Executive Director has taken the following actions to ensure that adequate policies are in place to ensure compliance with the Financial Integrity Act which includes:

- To ensure that all information flows up and down, the Executive Director will be provided with a copy by staff of all communications requiring compliance with the Financial Integrity Act.
- The director of administrative services will be responsible for developing an internal accounting evaluation process with adequate controls to document compliance with the Financial Integrity Act and to prepare report and submit all compliance documents on or before the established deadlines.

SPECIAL INVESTIGATIONS

REPAYMENT OF FUNDS FROM THE TENNESSEE ARTS FOUNDATION TO THE TENNESSEE ARTS COMMISSION, AND CIRCUMVENTION OF PURCHASING POLICIES AND PROCEDURES

Origin of the Review

In August 2004, the Division of State Audit received information that the Tennessee Arts Foundation had collected and retained revenue related to a conference that was fully funded by the Tennessee Arts Commission. At that time, the Division of State Audit also received information that the Tennessee State Museum had violated purchasing procedures while procuring office equipment.

Issue 1

One issue presented for this review involved the amount of revenue collected by the foundation in connection with the 2004 Tennessee Stages Tennessee Stars conference. This revenue was composed of meal fees for the conference and sales of t-shirts at the conference.

All of the expenses related to the 2004 Tennessee Stages Tennessee Stars conference were paid with state appropriations allocated to the Tennessee Arts Commission. However, the Tennessee Arts Foundation collected a $25-per-person meal fee from the majority of the conference attendees. The foundation should have remitted the total amount collected from the attendees to the commission in order to offset the state's obligations related to the conference.

The commission also paid for 750 "Support the Arts" t-shirts. Although the majority of these shirts were given away, some were sold by the foundation at the 2004 Tennessee Stages Tennessee Stars conference, and some remain at the commission office. The foundation should have remitted the total amount collected from shirt sales to the commission in order to offset the state's costs related to their initial purchase.

Issue 2

The other issue presented for this review involved the lack of adherence to purchasing policies and procedures for the procurement of three office chairs by Tennessee State Museum staff. Museum staff split the purchase of the chairs into three individual purchases, did not utilize existing statewide contracts, and purchased the items from a debarred vendor.

Objectives of the Review

The objectives of this review were

- to determine whether the foundation collected revenue from conference attendance fees;
- to determine whether the foundation collected revenue from the sale of t-shirts;
- to determine the amounts of these revenues;
- to determine whether the museum staff followed procurement policies and procedures;
- to report the findings to the commission;
- to recommend appropriate actions to recoup any funds collected by the foundation for events or items funded by the commission; and
- to recommend appropriate actions to ensure that procurement policies and procedures are followed.

Scope of the Review

During the review, the Division of State Audit interviewed relevant personnel from the Tennessee Arts Commission, the Tennessee Arts Foundation, and the Tennessee State Museum. Invoices, copies of registrants' checks, receipts, commission meeting minutes, travel claims, and other related documents were reviewed. The foundation's check register for the period from October 7, 2002, to September 10, 2004, was also reviewed. Based on this information, calculations were performed to determine the amount collected by the foundation that should have been directed to the commission.

11. The Tennessee Arts Commission did not require the repayment of $2,700 from the Tennessee Arts Foundation

Finding

The Tennessee Arts Commission receives funds from various sources, including the National Endowment for the Arts, the sale of specialty license tags, and direct state appropriations of taxpayer dollars. The commission, as a state entity, receives all of these funds with fiduciary responsibilities. As such, the commission, its Executive Director, and its staff have a duty to safeguard its assets and properly account for its assets and operations in compliance with state laws intended to assure taxpayers that their resources are not being wasted or abused.

The Tennessee Arts Foundation is a 501(c)(3) tax-exempt corporation that was organized to support and extend the usefulness of the Tennessee Arts Commission. According to the bylaws of the Tennessee Arts Foundation, the Executive Director of the commission also serves as the ex-officio secretary/treasurer of the foundation. Also, according to the bylaws, the chair of the Tennessee Arts Commission serves as the Vice Chairman of the foundation.

The Executive Director did not require the Tennessee Arts Foundation to return funds collected for the 2004 Tennessee Stages Tennessee Stars conference to the state. Although the conference was funded entirely with state funds, conference attendees were directed, by published conference materials, to make their checks for conference attendance fees payable to the foundation. As a result, the foundation collected revenue totaling $2,660 in the form of conference attendance fees. This revenue was retained by the foundation and was deposited in the foundation’s bank account. The foundation did not transfer the funds to the state as a means of offsetting the state’s obligations related to the conference.

Furthermore, the Executive Director of the commission did not require the Tennessee Arts Foundation to return funds collected from the sale of t-shirts at the conference. According to the Executive Director of the commission, 750 t-shirts were purchased, with state funds by the commission, at a total cost of $5,002.50, or $6.67 each, with the intent to be used as promotional items. According to the Executive Director, the majority of the shirts were distributed for no charge to registrants at the 2003 Governor’s Regional Conferences on the Arts, commission employees and members, and various others; and, some shirts remain in boxes at the commission office. However, based on sales receipts, 8 shirts were sold at the 2004 Tennessee Stages Tennessee Stars conference for $5 each, resulting in total revenue of $40. The buyers were directed by a sign, with the conference logo, to make their checks payable to the foundation. This revenue was retained by the foundation and was deposited in the foundation’s bank account. The foundation did not transfer the funds to the state as a means of offsetting the state’s costs related to the purchase of the shirts.

By failing to safeguard the state’s interest by requiring the foundation to return these revenues, the Executive Director of the commission did not adequately fulfill his duty to safeguard the commission’s assets and properly account for the commission’s assets and operations in compliance with state laws intended to assure taxpayers that their resources are not being wasted or abused.

Based on discussion with the Executive Director, he did not even consider whether the funds collected by the foundation should go back to the state. He stated that he merely assumed the money could be used for “arts.” Based on review of minutes from the commission’s Allocations Committee meeting on May 21, 2003, $30,000.00 was approved to be used for the conference. Also, based on review of minutes from the commission meeting on June 12, 2003, this amount was approved by the commission. Furthermore, the Executive Director obtained approval from the Department of Finance and Administration to pay expenses incurred as a result of the conference. However, no documentation was available to indicate any approval for funds collected in relation to the conference to go to the foundation rather than to the state to offset the state’s obligations related to the conference. The commission also was not informed of the misdirection of revenues earned from the conference. Based on discussions with the past two chairs of the commission, they relied on the Executive Director and the staff of the Tennessee Arts Commission to keep them informed and to appropriately manage the day-to-day operations of the commission. The former chairs of the commission, with whom we discussed these matters, are the current and immediate past chairs of the foundation, respectively. Based on further discussions with these individuals, there have been no foundation board meetings at any time during their association with the foundation.

As a result of this review, the Tennessee Arts Foundation remitted the $2,660 from conference attendance fees and the $40 from shirt sales to the Tennessee Arts Commission. These funds were received from the foundation and were deposited by the commission on November 18, 2004.

Recommendation

The Executive Director should ensure that any revenue collected by the foundation related to events funded by the state or purchases made with state funds is promptly remitted to the state. Also, the Executive Director and other commission staff should inform the commission of all sources of funding, revenues, and expenses, as they relate to commission projects, in order for the commission members to exercise proper due care in the safeguarding of commission assets.

According to its own bylaws, the Tennessee Arts Foundation board is "vested with the powers to operate, manage, control and supervise the activities of the foundation." Also, according to its bylaws, the foundation board is required to meet annually and the secretary/treasurer is required to make a full written report of the financial condition of the foundation. It is further stated in the bylaws that, in the event it is impossible to schedule an annual meeting, the business of the foundation may be conducted by a polling of the trustees and a proxy vote. In accordance with these bylaws, the foundation board should, at a minimum, attempt to hold the required annual meeting in order to provide some oversight of foundation resources. Furthermore, in the event that the business of the foundation is conducted by polling the trustees and by holding a proxy vote, this process should be well documented. Also in accordance with the bylaws, the foundation board should require financial reports from the secretary/treasurer that provide a detailed listing of all revenues and expenses. These financial reports should include, at a minimum, sources of revenues and purposes of expenses. Also, foundation board members should formally review these reports and document their approval of revenues received and expenses incurred. Furthermore, the foundation board should revise its bylaws to provide for more frequent meetings and should require attendance of the foundation board members in order to provide adequate and appropriate oversight of all of the foundation's affairs.

The risk of commingling funds and other assets between the foundation and the commission is greatly heightened by the sharing of staff between the two entities. The foundation board should revise its bylaws, removing or effectively editing the articles that make the Executive Director of the Tennessee Arts Commission the ex-officio secretary/treasurer of the foundation and that make the Chair of the commission the Vice Chairman of the foundation. The foundation board should also adopt policies to ensure that the secretary/treasurer of the foundation is not directly involved in the day-to-day operations of the Tennessee Arts Commission. Moreover, the commission's Executive Director should serve as neither secretary nor treasurer of the foundation. Furthermore, both the commission and the foundation should adopt policies providing clear and absolute separation between commission members/staff and foundation members/staff. No individual associated with one entity should have an official capacity with the other. This will enable the commission board and the foundation board to effectively remove the appearance of conflicts of interest in the Executive Director and secretary/treasurer positions, as well as in the commission Chair and foundation Vice Chairman positions. This will also enable the foundation board to provide better oversight of foundation resources.

Management's Comment

We concur with explanation. The Tennessee Arts Foundation was incorporated in 1988 as a non-profit organization for the purpose to support and extend the activities and usefulness of the Tennessee Arts Commission; to establish and maintain an endowment; to collect and maintain other funds for the support of the Tennessee Arts commission's public functions and special projects and to accept loans and bequests and devises of property.

Funds raised by the Arts Foundation have been used to enhance the work of the Commission through special projects sponsored by the agency, i.e., Governor's Awards in the Arts, Advocating for the Arts Statewide Conference, Governor's Regional Conferences on the Arts, Cultural Crossroads Conference, Tennessee Stages…Tennessee Stars Presenter's Conference. The Foundation acts as a repository for any special funds collected for one-time projects or a mechanism to collect funds for expressions of sympathy or caring for sick or deceased Commission members and staff. Limited funds are collected as neither the Commission, nor the Foundation wishes to be in the business of competing for private dollars with organizations funded by the agency.

When the Commission sponsors a special project, a budget to produce these events is always developed for approval by the Department of Finance and Administration. If a statewide meeting is held, a small registration fee is established to encourage attendance and to discourage participants from registering and then not attending. As had been done with other Commission sponsored conferences, the agency believed registration fees could be used to cover unbudgeted expenses related to conference activities. The Tennessee Stages…Tennessee Stars Presenters Conference incurred no such expenses and the registration fees were deposited to the Tennessee Arts Foundation for future Commission sponsored activities. These funds should have been remitted back to the state in the year they were collected.

In 2003 the Commission provided "Support the Arts….Bolt'em to you car" t-shirts to all participants attending the three Governor's Regional Conferences on the Arts, (September 9 at Pickwick Landing State Park, on September 25 at Arrowmont School of Arts and Crafts in Gatlinburg and on October 8 at Henry Horton State Park). The Commission provided these t-shirts as an inducement to attend the conferences and as a way to promote the sale of specialty license plates. 750 t-shirts were produced and based on attendance; the Commission estimated around 500 t-shirts was distributed to participants. Additionally, the Commission distributed t-shirts to individuals as gifts, and in April-May 2004, approximately 120 t-shirts were given to members of The National Symphony Orchestra (NSO) and staff as a gesture of hospitality. The NSO was on a ten-day tour of the state performing concerts and doing education outreach programs as part of the Orchestra's American Residency Tennessee Tour. Approximately eight t-shirts were sold at the Tennessee Stages…Tennessee Stars conference. The Commission failed to transfer the $40 collected the sale of the t-shirts from the foundation's bank account to the state. It was not the intent of the Executive Director, or the Commission not to be in compliance with state laws and assure taxpayers that their resources are being wasted.

The fifteen members appointed by the Governor serve in a voluntary capacity. They operate under Governing Policies that outlines their responsibilities as well as that of the Executive Director. According to Policy Governance they **must** approve the agency's budget each year. The Executive Director provides information about all aspects of the agency's on-going work and special projects that may involve the Foundation. The Tennessee Arts Foundation was created for specific purposes with limited activities. Members serving on the Board are all former Commission members and understand the limited amount of activity the Foundation is involved with. They understand that active participation is not required, nor the need to travel to attend board meetings due to the limited amount business conducted by the group.

The Executive Director of the Commission, according to the by-laws, serves as Executive Director of the Foundation and maintains all records and banking accounts for the organization. As previously stated the Foundation is involved in limited activities. The Executive Director keeps the Chair of the Foundation informed of any needed action by the group and is responsible for the filing of the organization's Corporation Annual Report and Form 990-EZ Income Tax which is completed by a certified public accountant each year. The Executive Director has always made the Commission aware of the Foundation's funds balance and has provided a copy of the most recently filed Form 990-EZ when requested.

When the current Executive Director of the Commission was appointed in November 1999, he inherited the Executive Director responsibilities of the Tennessee Arts Foundation. The Foundation had a history of infrequent board meetings and Howard Herndon, Chair of the Commission expressed to the newly appointed Executive Director that the Arts Foundation should not be a burden to him. As the outgoing TAC Chair and the Chair-Elect of the Foundation, he and other members of the Foundation Board decided that because of the limited activity and business conducted by the group, it was not feasible or cost efficient to ask board members to travel across the state to discuss issues that could be done by telephone communication or correspondence. The Executive Director has kept the Chairs of the Foundation and the Commission informed of Commission projects that involved funding other than state appropriation of federal dollars. The Chair of the Commission serves as Vice Chair of the Foundation. Within the last three years, the Tennessee Arts Foundation has raised private and foundation support for the 2003 Governor's Awards in the Arts, the National Symphony Orchestra's American Residency Tour of Tennessee in 2004, and the 2005 Governor's Awards in the Arts. The checking account of the Foundation is utilized as "money in-money out" for specific projects or activities of the Commission, always maintaining a small balance. As of April 30, 2006, the Arts Foundation's checking account balance is $7,402.74. The Arts Foundation holds a Certificate of Deposit as the result of bequest in the amount of $16,039.55.

The CD is renewed automatically every term from the time of its establishment almost 20 years ago.

Members of the Tennessee Arts Foundation Board, nor members of the Tennessee Arts Commission, have been solicited to raise funds for the Foundation for support of special projects or activities. In almost every instance, the Executive Director has secured funding from corporate support to enhance special activities of the Commission. Because the Tennessee Arts Foundation is recognized by the Internal Revenue Service with a 501(c)(3) tax exempt status under the Internal Revenue Code, small contributions (none exceeding $100) have been made by Commission members to cover expenses such as memorial gifts, retirement gifts and flowers upon the death of former Commission or staff member's family or sickness of current Commission members. If sufficient funds are not available to cover these gifts, the Executive Director personally covers these expenses. According to the by-laws the Executive Director has the authority to write checks up to $500 without the approval of the Chair of the Foundation. Any amount above $500 must be approved by the Chair.

The Chair of the Tennessee Arts Commission appointed a Strategic Planning/Governance Inter-Board Committee in September in 2005 to assist the staff in the development of a five year strategic plan that would also include a review of the relationship between the Arts Commission and Arts Foundation.

The Executive Director will work with the Chairs of the Tennessee Arts Foundation and the Tennessee Arts Commission to address audit findings and to define the role of the Arts Foundation in supporting the work of the Tennessee Arts Commission.

The Executive Director of the Commission has never benefited personally in his role as Executive Director of the Foundation. To the contrary, he has personally contributed to cover expenses of the Foundation. Neither the Chair of the Commission or the Chair of the Arts Foundation believe the Executive Director has acted in an inappropriate or less than ethical manner in providing oversight of the Commission and Foundation resources.

12. Purchases of three chairs totaling $722.93 were misrepresented in order to circumvent purchasing policies and procedures

Finding

On July 6 and July 8, 2004, museum staff ordered three chairs for a total of $722.93 from an office-supply vendor. The museum staff improperly treated the transactions as three separate purchases, each under $400, and did not obtain three bids as required. State purchasing policies and procedures require approval for purchases over $400 but less than $2,000 to be requested on the front end and require three competitive bids (price comparisons) documented and approved on the Tennessee On-Line Purchasing System (TOPS). Although the account technician for the museum stated that she compared prices with other office-supply vendors, these comparisons were not documented so her statement could not be verified. In addition, the chairs were ordered and received before the purchasing requests and approvals were sought. Also, similar items on statewide contract were not utilized as required by policy. State purchasing policies require that purchases be made from already existing statewide contracts to take advantage of cost-savings.

We were able to make price comparisons on-line for two of the chairs. Based on these comparisons, it appears that museum staff could have saved up to $60 on one chair and up to $30 on the other chair. However, these variances could be due to a timing difference of approximately ten months from the date the chairs were purchased to the date we made the on-line comparisons. We were unable to find comparisons for the third chair. Also, based on review of the chairs available on statewide contract, it appears that the most comparable chairs available at the time would have cost approximately $400 each—more than the amount paid by the museum.

Before the chairs were purchased, the chair vendor had been placed on inactive status (debarred) by the Department of General Services due to the vendor's lack of a response to the department's correspondence regarding free gifts sent with the vendor's shipments to state agencies and departments. As a result, the payment for the transaction could not be processed on TOPS. Because the vendor payment could not be processed normally, the account technician sought an alternative payment method. The account technician processed the payment through the State of Tennessee Accounting and Reporting System (STARS). She stated that the chairs had already been received at the museum and that she was simply trying to pay the vendor for them.

The account technician explained that she first tried to process the payment through TOPS, but TOPS showed that the vendor status was inactive. The museum's account technician stated that she understood, at that point, that the vendor had been debarred. She further stated that her primary concern was to promptly process the payment to the vendor because the chairs had already been received and had already been put into use by the museum. To process the payment, she utilized the only other option she knew, and that was to process the vendor payment through STARS. The account technician stated that she did not seek advice or other guidance regarding this deviance from the payment process at any point before or after she deviated from the normal process.

After the museum's account technician had processed the payment through STARS, the payment had to be approved by the former Director of Administrative Services and the Executive Director of the Tennessee Arts Commission. When the payment documentation reached the commission offices, it was reviewed by the commission's account technician, who noticed that the processing was done in error and notified the former Director of Administrative Services. The former Director of Administrative Services then inquired as to why the payment had been processed in this manner and was informed by the museum's account technician that the chairs had already been ordered and received and that she was unable to process the payment through TOPS because the vendor had been debarred. According to the former Director of Administrative Services, she felt that the state was obligated to pay for the chairs at that point. Therefore, she signed her approval of the payment and presented it to the Executive Director for his approval. The former Director of Administrative Services stated that she made the Executive Director aware that the purchases had been made from a vendor that had been debarred by the state. The Executive Director, however, stated that the only time he became aware of any issues with the payment was when he was questioned by auditors after the payment had been made. The Executive Director further stated that he assumed that, since the former Director of Administrative Services had approved the payment, it was correct. Therefore, he signed his approval of the payment.

Recommendation

It is clearly improper for a state official to purchase equipment from a vendor that has been debarred by the state. One of the first steps in the purchasing process should be determining whether a vendor is debarred or not. If a vendor is in fact debarred, no purchases should be initiated with that vendor. It also is clearly improper to order and receive items before obtaining the proper approvals authorizing the purchases. No items should be ordered prior to obtaining appropriate authorization. Further, once the museum's accounting technician determined that the vendor was debarred and payment could not be processed through normal channels, she should have promptly notified her superiors, including the Executive Director, and should have initiated the return of the merchandise. Moreover, it is completely unacceptable for purchasing staff, once they are put on notice that a payment cannot be processed normally, through TOPS, to circumvent existing state purchasing controls by utilizing the STARS system in an inappropriate manner to effectuate payment.

The museum's management should ensure that staff is fully informed and follows purchasing policies and procedures. The museum's management should also ensure that staff seeks advice from immediate supervisors, budget officers, and/or the Department of General Services before taking actions that may be considered a violation or circumvention of purchasing policies and procedures. Furthermore, the museum's management should ensure that employees don't take matters into their own hands, circumvent existing policies and procedures, and assume that there will be no consequences.

The Tennessee Arts Commission should adopt procedures to ensure that commission staff approval is required and obtained before items are ordered by the Tennessee State Museum, in order to provide adequate and appropriate oversight of the museum's purchases.

Management's Comment

We concur. Purchases of three chairs were made not following state policies and procedures. The current management of the Museum does not believe the transaction in question to be a deliberate and malicious attempt to circumvent the purchasing policies. These purchases were made and approved by both of the former Director of Administrative Services for the Commission and the Director of Administration for the Museum.

All purchases made by the Tennessee State Museum will be in compliance with State of Tennessee Purchasing Procedures. Museum staff with procurement responsibilities has been cautioned to always obtain appropriate supervisory approval prior to any purchase and to secure management advice and approval in the disposition of any irregularities. Museum staff will secure Tennessee Arts Commission prior purchase approval as is appropriate to remain in compliance with all purchasing regulations as well as to provide adequate control and over sight of purchase activities.

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

On May 19, 2005, the Tennessee General Assembly enacted legislation known as the "State of Tennessee Audit Committee Act of 2005." This legislation requires the creation of audit committees for those entities that have governing boards, councils, commissions, or equivalent bodies that can hire and terminate employees and/or are responsible for the preparation of financial statements. Entities, pursuant to the act, are required to appoint the audit committee and develop an audit committee charter in accordance with the legislation. The ongoing responsibilities of an audit committee include, but are not limited to:

1. overseeing the financial reporting and related disclosures, especially when financial statements are issued;
2. evaluating management's assessment of risk and the agency's system of internal controls;

3. formally reiterating, on a regular basis, to the board, agency management, and staff their responsibility for preventing, detecting, and reporting fraud, waste, and abuse;
4. serving as a facilitator of any audits or investigations of the agency, including advising auditors and investigators of any information it may receive pertinent to audit or investigative matters;
5. informing the Comptroller of the Treasury of the results of assessment and controls to reduce the risk of fraud; and
6. promptly notifying the Comptroller of the Treasury of any indications of fraud.

Subsequent to the completion of fieldwork, the Tennessee Arts Commission created a five-member audit committee at its quarterly meeting on March 8, 2006. On June 8, 2006, the commission approved the audit committee charter. The audit committee charter was approved by the Comptroller of the Treasury on July 6, 2006.

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 Arts Commission filed its compliance reports and implementation plans on June 27, 2002, June 30, 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

Tennessee Arts Commission division and allotment codes:

316.25 Tennessee Arts Commission
316.27 Tennessee State Museum