AUDIT REPORT

Military Department of Tennessee

December 2006

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

Arthur A. Hayes, Jr., CPA, JD, CFE
Director

Charles K. Bridges, CPA
Kandi B. Thomas, CPA, CFE
Assistant Directors

Teresa L. Hensley, CPA
Audit Manager

Bridget Carver, CFE
In-Charge Auditor

Jennifer Lewis, CFE
Tana L. Burks
Staff Auditors

Amy Brack
Editor

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
(615) 401-7897

Financial/compliance audits of state departments and agencies are available on-line at www.comptroller.state.tn.us/sa/reports/index.html.
For more information about the Comptroller of the Treasury, please visit our website at www.comptroller.state.tn.us.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

December 1, 2006

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Major General Gus L. Hargett, Jr., Adjutant General
Military Department of Tennessee
3041 Sidco Drive
Nashville, Tennessee 37204

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Military Department of Tennessee for the period April 1, 2003, through May 31, 2006.

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
06/058

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 401-7897
FAX (615) 532-2765

June 22, 2006

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 Military Department of Tennessee for the period April 1, 2003, through May 31, 2006.

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 Military Department of Tennessee's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Military Department of Tennessee 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 department's management 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 department's internal control and instances of noncompliance to the Military Department of Tennessee's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr.

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
Military Department of Tennessee
November 2006

AUDIT SCOPE

We have audited the Military Department of Tennessee for the period April 1, 2003, through May 31, 2006. 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 expenditures, the Station Commanders' Upkeep and Maintenance Funds, payroll, equipment, 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 FINDINGS

The Department Did Not Comply With the Procedures for the Station Commanders' Upkeep and Maintenance Funds (SCUMF)
Annual inspections were not usually performed on the SCUMF, and SCUMF quarterly reports were not always received by the 15th of the month following the end of the quarter as required by the procedures (page 6).

The Department Did Not Have Adequate Controls Over Equipment Purchased During an Emergency
The department did not have written policies and procedures for accounting for equipment items bought during an emergency. As a result, the department did not maintain proper accountability over equipment that was purchased for Hurricane Katrina shelters (page 10).

Financial and Compliance Audit
Military Department of Tennessee

TABLE OF CONTENTS

Financial and Compliance Audit
Military Department of Tennessee

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Military Department of Tennessee. 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 Adjutant General is responsible for the administration of the Military Department of Tennessee. The department's four major divisions are outlined below.

Administrative Services

Management Services provides the following state-financed services: preparation and execution of the budget; fiscal and accounting services; management and training of personnel; and procurement, inventory control, and issue of supplies, material, and equipment. The Bureau of War Records compiles and preserves records of Tennessee war veterans.

The department's Public Affairs Office deals with the news media. Included in the department are the federally oriented sections—United States Property and Fiscal Office, Inspector General, and Support Personnel Military Office—and their federal positions.

Tennessee Army National Guard

The Tennessee Army National Guard is under the direction of an Assistant Adjutant General and is required, under the provisions of the National Defense Act, to furnish armory, office, and storage facilities for the care and safekeeping of materials and equipment furnished by the federal government, and to provide the maintenance and operating costs of these facilities. The Assistant Adjutant General for the Tennessee Army National Guard is also responsible for the Tennessee State Guard and management of the various Station Commanders' Upkeep and Maintenance Funds throughout the state. The Tennessee State Guard is a voluntary organization that would provide personnel for the armory locations throughout the state in the event the National Guard was placed on active duty.

Tennessee Air National Guard

The Assistant Adjutant General for the Tennessee Air National Guard is responsible for the operation and maintenance of the Air National Guard facilities in Nashville, Memphis, Chattanooga, and Alcoa.

Emergency Management

The Tennessee Emergency Management Agency is under the administration of the Military Department of Tennessee. The division administers a statewide system of civil preparedness and coordinates the efforts of state departments and local civil defense organizations in emergency and disaster assistance and planning.

An organization chart of the department is on the following page.

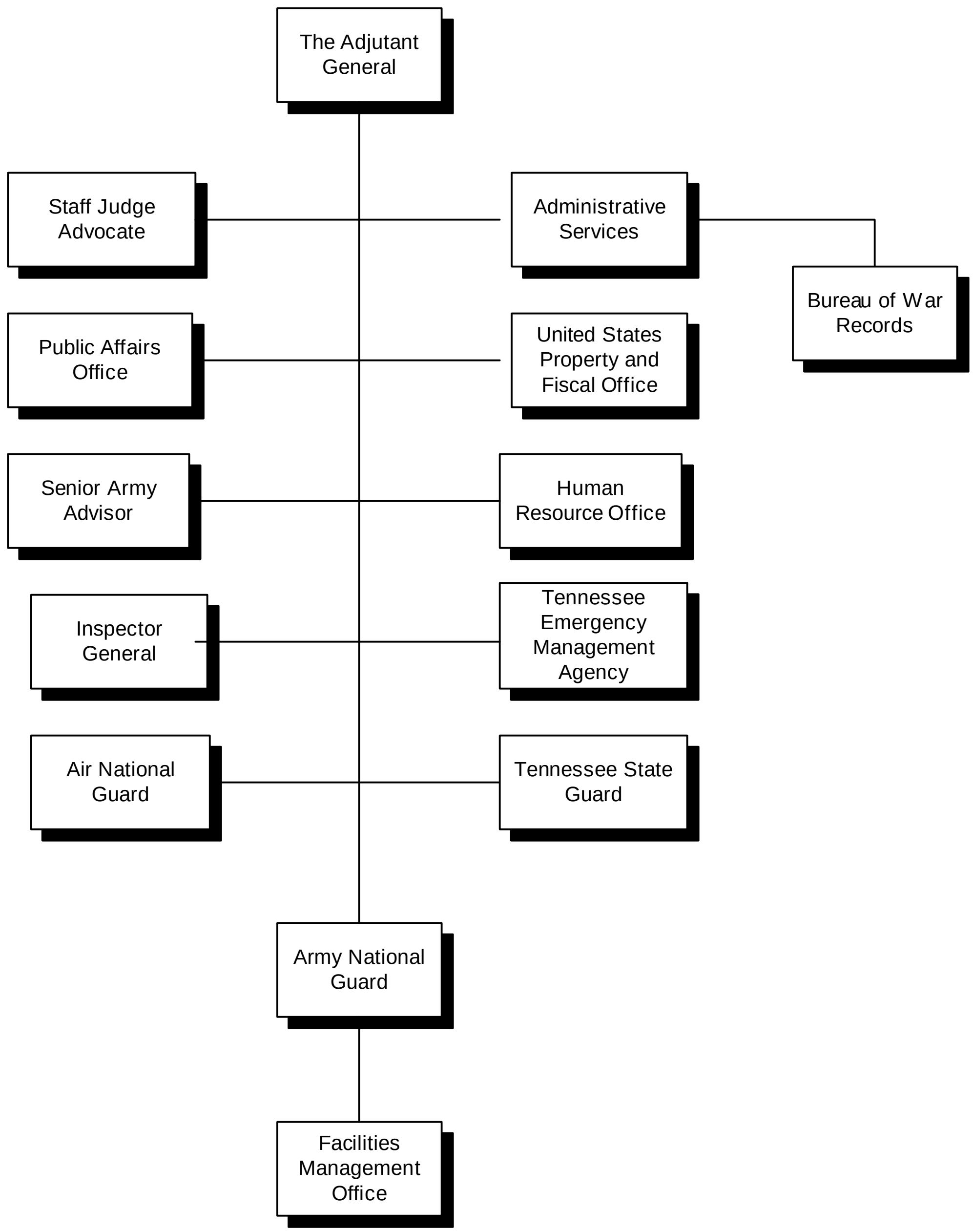
AUDIT SCOPE

We have audited the Military Department of Tennessee for the period April 1, 2003, through May 31, 2006. 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 expenditures, the Station Commanders' Upkeep and Maintenance Funds, payroll, equipment, 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 FINDING

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Military Department of Tennessee filed its report with the Department of Audit on January 28, 2004. A follow-up of the prior audit finding was conducted as part of the current audit.

MILITARY DEPARTMENT OF TENNESSEE ORGANIZATION CHART



The current audit disclosed that the department has substantially corrected the previous finding concerning inadequate controls over equipment; therefore, the finding has not been repeated.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

EXPENDITURES

Our review focused on determining whether

- recorded expenditures for goods and services were adequately supported, properly approved, and correctly recorded in the state's accounting system;
- payments to vendors were made promptly;
- expenditures were in compliance with applicable state regulations;
- contract payments complied with contract terms and purchasing guidelines and were properly approved and recorded against the contract;
- sole-source contracts were justified; and
- access to the State of Tennessee Accounting and Reporting System (STARS) and the Tennessee On-Line Purchasing System (TOPS) was properly restricted.

We interviewed key personnel to gain an understanding of management controls. A nonstatistical sample of expenditures for the period April 1, 2003, through December 31, 2005, was selected and tested to determine if expenditures were adequately supported, properly approved, correctly recorded, paid timely, and in compliance with applicable contract terms, rules, and regulations. The department had one sole-source contract during the period April 1, 2003, through February 28, 2006, and we tested this contract to determine if the department had adequate justification for using the sole-source contract.

We obtained a current listing dated August 8, 2005, of all persons assigned to the department with update/edit access to STARS. We tested the entire population and determined if the persons were employees as of the date of the listing, had job duties which required their designated level of access, and whether this level of access created an inadequate segregation of duties. We also obtained a current listing dated January 31, 2006, of all persons assigned to the department with update/edit access to TOPS. We tested the entire population and determined if the persons were employees as of the date of the listing, had job duties which required their designated level of access, and whether this level of access created an inadequate segregation of duties.

Based on the testwork performed, we determined that recorded expenditures for goods and services were adequately supported, properly approved, and correctly recorded in the state's accounting system; payments to vendors were made promptly; expenditures were in compliance with applicable state regulations; and contract payments complied with contract terms and purchasing guidelines and were properly approved and recorded against the contract. We also determined that the sole-source contract was justified, and access to STARS and TOPS was properly restricted.

STATION COMMANDERS' UPKEEP AND MAINTENANCE FUNDS

Money received for National Guard armory rentals is deposited into the station commanders' funds and used for upkeep and maintenance of armories. The objectives of our review were to determine whether

- appropriate accounting records were maintained;
- receipts were prepared for all money received, and the money was deposited timely;
- expenditures for goods and services were authorized and allowable;
- contracts were executed for all rentals of the armories;
- payments for armory rentals were received;
- Station Commanders' Upkeep and Maintenance Funds were monitored; and
- quarterly reports were submitted timely with the required information.

We interviewed key personnel to gain an understanding of management controls. We visited six armories (Nashville, Columbia, Lewisburg, Kingsport, Knoxville, and Ashland City) and reviewed all the accounting records and supporting documentation for the station commanders' funds for the period October 1, 2005, through December 31, 2005, and determined if appropriate accounting records were maintained, receipts were prepared and the money was deposited timely, expenditures were authorized and allowable, contracts were executed for all rentals of the armories, and rental fees were received.

We obtained a listing of all the station commanders' funds at September 30, 2005. From the listing, we selected a nonstatistical sample and reviewed the monitoring documentation for the station commanders' funds to determine if the required number of annual inspections were performed between April 1, 2003, and March 7, 2006, on the station commanders' funds. In addition, a nonstatistical sample of quarterly reports for the period April 1, 2003, through December 31, 2005, was selected and tested to determine if the quarterly reports were submitted timely with the required information.

Based on the testwork performed, we determined that appropriate accounting records were maintained, receipts were prepared for all money received, expenditures for goods and services were authorized and allowable, contracts were executed for all rentals of the armories, and payments for armory rentals were received. We determined that money was deposited timely with minor exceptions. The quarterly reports were submitted with the required information with minor exceptions. However, the station commanders' funds were not always adequately monitored, and the quarterly reports were not always submitted timely, as discussed in finding 1.

1. **The department did not comply with the procedures for the Station Commanders' Upkeep and Maintenance Funds, and as a result, did not mitigate all risks associated with such noncompliance**

Finding

The Station Commanders' Upkeep and Maintenance Funds (SCUMF) are used for upkeep and maintenance of the National Guard armories, and money received for armory rentals is deposited into the SCUMF. The department's *Maintenance Management Standard Operating Guidance* manual provides uniform procedures for management of the SCUMF. During the audit period, the department did not ensure that annual inspections were performed on the SCUMF or that SCUMF quarterly reports were received timely as required by the procedures.

Testwork on a sample of 35 SCUMF revealed that annual inspections were usually not performed. The required numbers of annual inspections were not performed between April 1, 2003, and March 7, 2006, on 33 of 35 SCUMF tested (94%). The following problems were noted:

- Sixteen of 33 SCUMF did not have any inspections during the period April 1, 2003, through March 7, 2006.
- Twelve of 33 SCUMF only had one inspection during the period.
- Four of 33 SCUMF only had two inspections during the period.
- One of 33 SCUMF had three inspections during the period; however, all three inspections were conducted within one year rather than annually as required.

According to Paragraph 15, Appendix A, "Assistant Adjutant General-Army Procedures for the Station Commander's Upkeep and Maintenance Fund," of the *Maintenance Management Standard Operating Guidance* manual,

> ANNUAL INSPECTIONS: the Station's next higher headquarters on an annual basis will inspect all SCUMF records. Results of the inspection will be recorded on an inspection checklist (Annex Q) and maintained in the Reference Publication File of both the inspected unit and the next higher headquarters.

Testwork on a sample of 25 SCUMF quarterly reports revealed that the reports were not submitted timely. Twenty-one of 25 reports tested (84%) were not received by the 15th of the month following the end of the quarter. The SCUMF quarterly reports ranged from 4 to 138 days late. Paragraph 14, Appendix A, of the *Maintenance Management Standard Operating Guidance* manual states,

> QUARTERLY REPORT: Each Fund Custodian shall furnish a financial report at the end of each calendar quarter to arrive not later than the 15th of the following month. The report shall include the quarterly reconciliation report (Annex L) and a roll-up of all income received and expenditures (Annexes M and P). . . .

Management of the department has not assigned specific responsibility for ensuring that annual inspections of SCUMF are performed. Failure to ensure that annual inspections are conducted on the SCUMF and that quarterly reports are received timely can lead to inappropriate expenditures and increases the risk of theft or misappropriation of state funds. Annual inspections on the SCUMF and timely submission of the quarterly reports are necessary to safeguard and account for the funds.

Recommendation

Management should ensure that annual inspections are conducted on the SCUMF and that SCUMF quarterly reports are received by the 15th of the month following the end of the quarter. In addition, management should ensure that the risks noted in this finding, as well as other risks of noncompliance, fraud, waste, or abuse in the department, are adequately identified and assessed in management's documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to adequately mitigate those risks and 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. All controls and control activities, including monitoring, should be adequately documented.

Management's Comment

We concur. Management is in the process of creating a new internal review section that will be responsible for the ongoing monitoring and compliance of all written requirements and responsible for taking prompt action when exceptions occur. One of the main duties of this section is to bring the department into compliance with all internal written policies and procedures in regard to Station Commander's Funds. This new section will also design and implement internal controls to mitigate risks. This section will report directly to the Director of Administrative Services, thereby maintaining independence from each division within the Military Department (TEMA, Army, Air).

PAYROLL

Active State Duty

The Military Department of Tennessee uses an internally developed system to calculate the payroll for active state duty individuals. Our objectives in reviewing the active state duty payroll focused on determining whether

- there was a properly completed request for orders on file;
- there was a properly completed time sheet on file, if applicable;
- gross pay was calculated correctly;
- all allowances agreed with the approved pay schedules; and
- the federal income tax and FICA withheld were calculated correctly.

We interviewed key personnel to gain an understanding of management controls. Also, a nonstatistical sample of payroll expenditures made to persons on active state duty between April 1, 2003, and December 31, 2005, was selected and tested. For each expenditure tested, we determined whether there was a properly completed request for orders and time sheet on file, gross pay was calculated correctly, all allowances agreed with the approved pay schedules, and the federal income tax and FICA withheld were calculated correctly.

Based on the testwork performed, we determined that there were properly completed requests for orders and time sheets on file, gross pay was calculated correctly, and that all allowances agreed with the approved pay schedules. We also determined that the federal income tax and FICA withheld were calculated correctly with minor exceptions.

Federal Active Duty

Our objectives in reviewing attendance and leave records for department employees who also served on federal active duty were to determine whether

- employees on military leave from the state were actually serving on federal active duty; and
- employees paid by the federal government for active duty were on leave from the state during that time.

We obtained a listing of employees who had taken the maximum allowable amount of military leave during calendar year 2005 and selected a nonstatistical sample. For the employees in the sample, we obtained their state attendance and leave records for calendar year 2005 and their federal attendance calendars that show the dates and types of federal active duty for calendar year 2005. We compared the state and federal attendance records to determine if employees took leave appropriately.

Based on the testwork performed, we determined that employees on military leave from the state were actually serving on federal active duty. We also determined that employees paid by the federal government for active duty were on leave from the state during that time with some exceptions.

Temporary Employees

The objectives of our review were to determine whether

- the hiring of temporary employees was properly approved; and
- the period of time that temporary employees worked for the department was in compliance with the applicable contract.

We obtained a listing of all temporary employees that worked for the department between April 1, 2003, and March 31, 2006, and tested the entire population to determine whether the hiring was properly approved and whether the period of time that temporary employees worked for the department was in compliance with the applicable contract.

Based on the testwork performed, we determined that the hiring of temporary employees was properly approved and that the period of time that temporary employees worked for the department was in compliance with the applicable contract.

EQUIPMENT

The objectives of our work in the area of equipment were to determine whether

- expenditures charged to equipment costing at least $5,000 reconciled to equipment additions in the Property of the State of Tennessee (POST) system costing at least $5,000;
- the information on the department's equipment listed in POST was accurate;
- the department maintained proper accountability over equipment;
- equipment leased from the Office for Information Resources (OIR) could be located and was properly tagged;
- vehicles leased from Motor Vehicle Management could be located and were used for business purposes; and
- employee access to POST was appropriate.

We interviewed key personnel to gain an understanding of management controls. We obtained a listing of all the department's expenditures in the State of Tennessee Accounting and Reporting System (STARS) charged to object code 16 (Equipment) during the period July 1, 2004, through June 30, 2005, with a cost of at least $5,000. We obtained a listing of all equipment in POST assigned to the department charged to object code 16 with a cost of at least

$5,000 and an acquisition date during the period July 1, 2004, through June 30, 2005. We compared the listings to determine whether the two listings reconciled.

We obtained a current listing dated January 30, 2006, of all active equipment in POST assigned to the department. We selected a nonstatistical sample from the listing and determined if the items could be physically located, confirmed, or had transfer or surplus property documentation; if the state tags were attached to the equipment items; if the location codes, serial numbers, descriptions, and state tag numbers were properly recorded in POST; and if the costs, if acquired during the period April 1, 2003, through January 30, 2006, were properly recorded in POST. We also obtained a listing of the televisions and DVD/VCR players bought on September 5, 2005, for the shelters established in Tennessee for people affected by Hurricane Katrina and determined if the equipment could be located, had a state tag attached, and was recorded in POST.

We obtained a current billing record for the period December 1, 2005, through December 31, 2005, of all equipment being leased from OIR by the department. We tested the entire population to determine whether the equipment could be located and was properly tagged. We obtained from Motor Vehicle Management a current listing dated February 1, 2006, of all vehicles being leased by the department. We selected a nonstatistical sample from the listing and determined if the vehicles could be located and were used for business purposes. We also obtained a current listing dated February 6, 2006, of all persons assigned to the department with update/edit access to POST. We tested the entire population and determined if the persons were employees as of the date of the listing, had job duties which required their designated level of access, and whether this level of access created an inadequate segregation of duties.

Based on the testwork performed, we determined that expenditures charged to equipment costing at least $5,000 reconciled to equipment additions in POST costing at least $5,000 with minor exceptions. The information on the department's equipment listed in POST was not always accurate, and the department did not always maintain proper accountability over equipment. This is discussed in finding 2. We also determined that equipment leased from OIR could be located and was properly tagged, and vehicles leased from Motor Vehicle Management could be located and were used for business purposes. In addition, employee access to POST was appropriate with a minor exception.

2. <u>The department did not have adequate controls over equipment purchased during an emergency, and as a result, did not mitigate all risks associated with controlling and safeguarding that equipment</u>

Finding

The Military Department did not have written policies and procedures for accounting for equipment items bought during an emergency. As a result, the department did not maintain proper accountability over equipment that was purchased for Hurricane Katrina shelters.

On September 5, 2005, the Department of General Services purchased 15 televisions and nine DVD/VCR players for the shelters established in Tennessee for people affected by Hurricane Katrina. However, Military Department staff did not ensure that the televisions and DVD/VCR players bought for the shelters were accounted for when they were returned to the Military Department. The department cannot locate four of the nine DVD/VCR players or locate the documentation showing the date five of the televisions and four of the DVD/VCR players were returned to the department. The other ten televisions and five DVD/VCR players were returned to the department between September 30, 2005, and October 13, 2005. As of June 14, 2006, the 15 televisions and nine DVD/VCR players had not been assigned a state tag number or entered into POST.

When proper equipment records are not accurately maintained, state tags are not attached to the equipment items, and there are no policies and procedures for accounting for items bought during an emergency, the risk increases that equipment will be lost or stolen and that the loss or theft will not be detected. Accurate and complete property records are necessary to safeguard and account for all state equipment in the department's custody.

Recommendation

Management should develop written policies and procedures for accounting for items purchased during an emergency and assign someone to be responsible for those items. Management should ensure that equipment items bought during an emergency are properly tagged and recorded in POST.

In addition, management should ensure that the risks noted in this finding, as well as other risks of noncompliance, fraud, waste, or abuse in the department, are adequately identified and assessed in management's documented risk assessment activities. Management should identify specific staff to be responsible for the design and implementation of internal controls to adequately mitigate those risks and 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. All controls and control activities, including monitoring, should be adequately documented.

Management's Comment

We concur. As of November 1, 2006, the Tennessee Emergency Management Agency (TEMA) has accounted for all equipment purchased during Hurricane Katrina with the exception of two DVD/VCR players with an estimated cumulative value of $200. TEMA has developed and implemented written policies and procedures for the purchase of supplies and equipment during a declared emergency. The effective date of this policy is July 1, 2006. This policy has been distributed to the appropriate personnel in TEMA. TEMA has assigned personnel to be responsible for items procured during an emergency.

These procedures and policies include the designation of a TEMA property officer to affix state property tags to equipment as applicable. Management is in the process of creating a new internal review section that will be responsible for the ongoing monitoring and compliance of all written requirements and responsible for taking prompt action when exceptions occur. This new section will also design and implement internal controls to mitigate risks. This section will report directly to the Director of Administrative Services thereby maintaining independence from each division within the Military Department (TEMA, Army, Air).

The Property/Procurement Section of the Military Department is providing ongoing training sessions for individuals involved in the procurement process and property management. This training consists of purchasing procedures, property accountability, correct invoicing, receipt and safeguarding of assets.

FINANCIAL INTEGRITY ACT

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

Our objectives were to determine whether

- the department's June 30, 2005; June 30, 2004; and June 30, 2003, responsibility letters and December 31, 2003, internal accounting and administrative control report were filed in compliance with Section 9-18-104, *Tennessee Code Annotated;*
- documentation to support the department's evaluation of its internal accounting and administrative control was properly maintained;
- procedures used in compiling information for the internal accounting and administrative control report were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated;* and
- corrective action has been implemented for the weakness identified in the report.

We interviewed key employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the department's procedures. We reviewed the June 30, 2005; June 30, 2004; and June 30, 2003, responsibility letters and the December 31, 2003, internal accounting and administrative control report to determine whether they had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration. We also reviewed the supporting documentation for the department's evaluation of its internal accounting and administrative control. To determine if the corrective action plan had been implemented, we interviewed management and reviewed the corrective action for the weakness identified in the report.

We determined that the Financial Integrity Act responsibility letters and internal accounting and administrative control report were submitted on time except for the internal accounting and administrative control report that was due December 31, 2003, which was received at the Comptroller's office on January 6, 2004, six days late. In addition, we determined that support for the internal accounting and administrative control report was properly maintained, procedures used were in compliance with *Tennessee Code Annotated*, and corrective action has been taken on the weakness noted.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

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

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

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

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, not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

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

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by June 30 each year. The Military Department of Tennessee filed its compliance reports and implementation plans on July 2, 2003; August 4, 2004; and July 1, 2005.

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.

SINGLE AUDIT FINDING

The Military Department of Tennessee was audited as part of the single audit of the State of Tennessee for year ended June 30, 2004, performed by the Comptroller's office. The single audit was conducted in accordance with the requirements of the Single Audit Act Amendments of 1996 and the provisions of Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. The following finding on the

Military Department of Tennessee was published in the *Single Audit Report* for the State of Tennessee for the year ended June 30, 2004.

Controls related to federal subrecipient monitoring requirements are insufficient

Finding

The Military Department of Tennessee is the state administrator of the Public Assistance Grants program, a federal assistance program. Following a presidential declaration of a major disaster or an emergency, the Federal Emergency Management Agency, Department of Homeland Security, awards public assistance to states. The state may use the funds to restore its own disaster-damaged projects and to provide subgrants to local governments. The Department of the Military provides subgrants to county and municipal governments. As such, the Military Department of Tennessee is a pass-through entity. A pass-through entity is a non-federal entity that provides a federal award to a subrecipient to carry out a federal program. The county and municipal governments are considered subrecipients and, as such, are required to be monitored by the Department of the Military. Our procedures indicated that controls established by management to comply with federal subrecipient monitoring requirements are insufficient to ensure compliance with monitoring requirements.

Based on discussion with management and review of subrecipient audit reports maintained at the Military Department of Tennessee, it appears management has established procedures to obtain audit reports for subrecipient counties that were audited by the Division of County Audit. However, no controls were in place to obtain audit reports for counties that were not audited by the Division of County Audit. In addition, no controls were in place to obtain audit reports for any subrecipient municipalities. Without adequate controls and procedures, management will not be able to comply with federal requirements for pass-through entities.

Office of Management and Budget Circular A-133, Section 400(d)(4), requires pass-through entities such as the Military Department of Tennessee to ensure subrecipients that expend $500,000 or more in federal awards during the subrecipient’s fiscal year have met the audit requirements of OMB Circular A-133 and that the required audits are completed within nine months of the end of the subrecipient’s audit period. In addition, OMB Circular A-133, Section 400(d)(5) requires pass-through entities to issue a management decision on audit findings within six months after receipt of the subrecipient’s audit report and to ensure that subrecipients take timely and appropriate corrective action on all audit findings. In cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity is required to take appropriate action using sanctions.

Recommendation

Management should establish controls to ensure compliance with pass-through entity responsibilities. Management should consider coordinating with the Division of Municipal Audit or contacting all subrecipients by mail to determine if its subrecipients are required to submit audit reports to the Military Department of Tennessee. Upon receipt of required audit reports, management should perform the pass-through entity's responsibilities as required by OMB Circular A-133, Section 400(d).

Management's Comment

We concur. Controls are now in place to monitor all 95 counties' audit reports. TEMA has coordinated with the Division of Municipal Audit for submittal of any audit findings on Military Department grants.

APPENDIX

ALLOTMENT CODES

Division of Administration	341.01
Tennessee Army National Guard	341.02
Tennessee Air National Guard	341.03
Tennessee Emergency Management Agency (TEMA)	341.04
Armories Maintenance	341.07
Homeland Security Grants	341.08
TEMA Disaster Relief Grants	341.09
Armories Utilities	341.10