

**Audit Results From
CAFR and Single Audit Procedures**

Department of Transportation

**For the Year Ended
June 30, 2006**

**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY**

Department of Audit

Division of State Audit

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**Department of Transportation
For the Year Ended June 30, 2006**

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**Department of Transportation
For the Year Ended June 30, 2006**

EXECUTIVE SUMMARY

Findings

- FINDING 1 The Department of Transportation has not developed a disaster recovery plan for certain vital system applications which run independently from the state's data center, increasing the risk of extended interrupted service in the event of an emergency or disaster (page 5).
- FINDING 2 The department did not always comply with the Copeland Act, increasing the risk that the department will fail to detect workers not receiving the prevailing wage rates (page 7).
- FINDING 3 The department did not always comply with OMB Circular A-133 regarding the monitoring of subrecipients, increasing the risk of the department not detecting problems with subrecipients (page 9).
- FINDING 4 The department incorrectly recorded the same capital assets in the accounting records in multiple years and has not updated its infrastructure policy to reflect current practice, increasing the risk of misstatements in the state's financial statements (page 12).

This report addresses reportable conditions in internal control and noncompliance issues found at the Department of Transportation during our annual audit of the state's financial statements and major federal programs. For the complete results of our audit of the State of Tennessee, please see the State of Tennessee *Comprehensive Annual Financial Report* for the Year Ended June 30, 2006, and the State of Tennessee *Single Audit Report* for the Year Ended June 30, 2006. The scope of our audit procedures at the Department of Transportation was limited. During the audit for the year ended June 30, 2006, our work at the Department of Transportation focused on one major federal program: Highway Planning and Construction. We audited this federally funded program to determine whether the department complied with certain federal requirements and whether the department had an adequate system of internal control over the program to ensure compliance. In addition, our work at the Department of Transportation included performing certain procedures to obtain reasonable assurance about whether capital asset amounts reported in the *Comprehensive Annual Financial Report* of the State of Tennessee were fairly stated. Management's response is included following each finding.



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

April 24, 2007

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Gerald F. Nicely, Commissioner
Department of Transportation
Suite 700, James K. Polk Building
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith are the results of certain limited procedures performed at the Department of Transportation as a part of our audit of the *Comprehensive Annual Financial Report* of the State of Tennessee for the year ended June 30, 2006, and our audit of compliance with the requirements described in the U.S. Office of Management and Budget Circular A-133 Compliance Supplement.

Our review of management's controls and compliance with laws, regulations, and the provisions of contracts and grants resulted in certain findings which are detailed in the Findings and Recommendations section.

Sincerely,

A handwritten signature in black ink that reads "John G. Morgan".

John G. Morgan
Comptroller of the Treasury

JGM/ddm
07/010



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
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December 21, 2006

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

Dear Mr. Morgan:

We have performed certain audit procedures at the Department of Transportation as part of our audit of the financial statements of the State of Tennessee as of and for the year ended June 30, 2006. Our objective was to obtain reasonable assurance about whether the State of Tennessee's financial statements were free of material misstatement. We emphasize that this has not been a comprehensive audit of the Department of Transportation.

We also have audited certain federal financial assistance programs as part of our audit of the state's compliance with the requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement. The following table identifies the State of Tennessee's major federal program administered by the Department of Transportation. We performed certain audit procedures on this program as part of our objective to obtain reasonable assurance about whether the State of Tennessee complied with the types of requirements that are applicable to each of its major federal programs.

**Major Federal Program Administered by the
Department of Transportation
For the Year Ended June 30, 2006
(in thousands)**

<u>CFDA Number</u>	<u>Program Name</u>	<u>Federal Disbursements</u>
20.205	Highway Planning and Construction	\$705,893

Source: State of Tennessee's Schedule of Expenditures of Federal Awards for the year ended June 30, 2006.

The Honorable John G. Morgan
December 21, 2006
Page Two

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

We have issued an unqualified opinion, dated December 21, 2006, on the State of Tennessee's financial statements for the year ended June 30, 2006. We will issue, at a later date, the State of Tennessee *Single Audit Report* for the same period. In accordance with *Government Auditing Standards*, we will report on our consideration of the State of Tennessee's internal control over financial reporting and our tests of its compliance with certain laws, regulations, and provisions of contracts and grants in the *Single Audit Report*. That report will also contain our report on the State of Tennessee's compliance with requirements applicable to each major federal program and internal control over compliance in accordance with OMB Circular A-133.

As a result of our procedures, we identified certain internal control and compliance issues related to the major federal program at the Department of Transportation. Those issues, along with management's response, are described immediately following this letter. We have reported other less significant matters involving the department's internal control and instances of noncompliance to the Department of Transportation's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee and management, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." The signature is written in a cursive style with a large, prominent initial "A".

Arthur A. Hayes, Jr., CPA
Director

FINDINGS AND RECOMMENDATIONS

1. The Department of Transportation has not developed a disaster recovery plan for certain vital system applications which run independently from the state's data center, increasing the risk of extended interrupted service in the event of an emergency or disaster

Finding

The Department of Transportation does not have a disaster recovery plan for applications which run independently from the Office for Information Resources (OIR) data center. A disaster recovery plan provides for the continuity of operational functions in case its applications are destroyed. Based on discussions with the Information Systems Director, the department runs its own applications which are considered vital to the department and the state. These applications include the Program, Project, and Resource Management (PPRM); Construction Management System (CMS); Maintenance Management System (MMS); Transportal; Oracle; and In-house client/server applications. Each application is described below:

- PPRM – PPRM is used to plan, schedule, and track the critical deadlines, tasks, resources, and budgets for the department's project development process. This system is the tool to ensure the project comes in on time and within budget. Also, the system facilitates the scheduling of department resources for workload projections and helps staff to determine when consultant services will be required, time phases for project development, and actual project commitments. PPRM was implemented in March 2001.
- CMS – CMS is a series of software applications that provide the following benefits to the department: improved project cost estimation from planning through construction phases; advanced bid letting processing with automated tracking and maintenance; management of construction projects via a centralized location for storing project information; and a means to capture, store, distribute, and analyze construction data. The software applications that make up CMS and their implementation dates are as follows: Proposal and Estimates System (February 1, 2002), Letting and Award System (February 1, 2002), Expedite (February 1, 2002), Bid Express (July 2005), Decision Support System (April 2002), Final Records (1999), and FieldBook (1999).
- MMS – This is an Oracle based system intended to enhance the department's effectiveness by taking advantage of maintenance management planning and execution and allowing tasks to be performed in an organized, systematic manner, so that predictable results and service levels can be achieved and so that the process can be better controlled. MMS was put into use on July 1, 2005.
- Transportal – Transportal is the department's intranet home page. It contains various

information including menus with links to major applications, utility programs, and other useful sites. It also displays a department calendar, the users' phonebook information, and leave balances. This system was implemented in early 2003.

- Oracle – This serves as the database in which data is stored by most applications used by the department.
- In House Client/Server Applications – These are small applications that were developed in-house. According to the Information Systems Director, there are approximately 250 of these small applications.

According to the Information Systems Director, the department's management has not had sufficient funding to develop the disaster recovery plan for the systems noted above. The potential for interrupted service and lost data increases significantly without an adequate recovery plan. In the event of an emergency or disaster, the department may not be equipped to carry out day-to-day operations which are supported by these applications.

Recommendation

The Commissioner of the Department of Transportation should ensure that a disaster recovery plan is developed for these in-house applications considered vital to the department and the state. Top management and the Information Systems Director should determine if a disaster recovery plan is needed for any other applications not included in this finding. The plan should document specific processes and procedures and might include, but not necessarily be limited to,

- guidelines for damage assessment,
- guidelines for declaring a disaster,
- guidelines for reporting a disaster to the alternate recovery site,
- a current list of recovery team members and telephone numbers,
- procedures for assembling the disaster recovery team,
- a definition of recovery team members' responsibilities,
- guidelines for press releases and media contacts,
- movement of backup files to the alternate recovery site,
- guidelines for recovering communication networks,
- detailed instructions for restoring disk files,
- detailed processing priorities, and
- restoration or relocation of the original processing site.

Management should include the risks noted in this finding in management's documented risk assessment.

The Commissioner should also ensure that other risks of improper accountability, noncompliance, fraud, waste, or abuse are adequately identified and assessed in management's documented risk assessment. Management should implement effective controls to ensure compliance with applicable requirements and assign staff to be responsible for ongoing monitoring of the risks and mitigating controls. Management should take appropriate action if deficiencies occur.

Management's Comment

We concur. The Tennessee Department of Transportation (TDOT) is knowledgeable about the risks to the department's technology operations and the need to have appropriate disaster recovery/business resumption controls. TDOT has already completed efforts to inventory all applications for the purpose of assessing their levels of criticality. Likewise, the IT Division will work closely with the department's Strategic Planning Division to ensure that disaster recovery processes are well-integrated into all TDOT business continuity planning.

TDOT will concentrate its early efforts primarily on the "business" portion of the disaster recovery plan and await OIR's establishment of enterprise disaster recovery capabilities (alternate recovery site). In the meantime, TDOT will join with OIR to consolidate its servers at the State's data center (providing a safer server environment and mitigating current risks). During this consolidation initiative, TDOT IT will consult with OIR to determine if the current server location in the Polk Building can serve as an alternate recovery site while OIR is working toward establishing enterprise disaster recovery facilities for the State.

2. The department did not always comply with the Copeland Act, increasing the risk that the department will fail to detect workers not receiving the prevailing wage rates

Finding

As noted in the prior audit, the department did not always receive payroll records from project contractors or subcontractors within the time frame required by the Copeland Act and failed to always date-stamp the payroll records when received.

The Copeland Act requires each contractor or subcontractor to submit to the department a weekly statement of the wages paid to each employee. Under the *Code of Federal Regulations*, Title 29, Chapter 1, Part 3, Section 4(a), contractors or subcontractors are required to submit certified payrolls, within seven days of the payroll pay date, to a representative of a federal or state agency at the site of the building or work. If no such representative of a federal or state agency is present at the site of the building or work, the certified payroll should be mailed to the federal or state agency within seven days. The payroll records are used by the department to determine if laborers and mechanics employed by contractors or subcontractors on federal contracts are being paid no less than the prevailing wage rates established for that locale by the U.S. Department of Labor.

Management stated in their response to the prior finding that “we will develop a policy to address...dating the payrolls when received.” The department management implemented the corrective action it had promised and drafted a new policy to address requirements of the timely receipt of contractor and subcontractor payroll records. However, the department did not have the formal written policy in place during our audit period of July 1, 2005, through June 30, 2006. The new policy requires the date-stamping of payroll records upon receipt. The new policy also includes steps to be taken if payroll records are not submitted to the department within seven days. The Commissioner approved the new policy on November 16, 2006. However, because management was not able to complete its corrective action plan during our current audit period, we were not able to review the department’s compliance with the new policy in regards to actions taken for the late submission of payroll records. We did test for the date-stamping of payroll records on a sample basis as discussed below in order to determine compliance with the Copeland Act.

We selected a sample of construction transactions. For the month of the transaction, we performed testwork to determine if the department complied with the Copeland Act for that month. We found the following problems in our testwork:

- For 8 of 44 construction transactions tested (18%), the project contractors or subcontractors did not submit or did not submit timely the certified payrolls for the month tested. Seven payrolls were received between 11 and 82 days late, and there was no evidence that one payroll was submitted at all. For an additional 11 payrolls, the date payrolls were received could not be determined since department staff did not date-stamp the payrolls when received. As a result, compliance with the Copeland Act could not be determined for these 11 construction transactions.

When the department does not develop and implement adequate formal policies and procedures to assure compliance with federal regulations, there is an increased risk that the department will fail to detect workers not receiving the prevailing wage rates.

Recommendation

The Commissioner and Chief Engineer should identify staff at the appropriate level to be responsible for ensuring that the department’s new policy for contractor payrolls is followed and that adequate training is provided to the employees. In addition, management should ensure adequate monitoring and oversight for all compliance requirements. Management should include the risks noted in this finding in management’s documented risk assessment.

The Commissioner should also ensure that other risks of improper accountability, noncompliance, fraud, waste, or abuse are adequately identified and assessed in management’s documented risk assessment. Management should implement effective controls to ensure compliance with applicable requirements and assign staff to be responsible for ongoing monitoring of the risks and mitigating controls. Management should take appropriate action if deficiencies occur.

Management's Comment

We concur. Since the end of the audit period, Departmental Policy Number 301-02 has been implemented. Effective November 16, 2006, this policy addresses compliance with both the Davis-Bacon Act and the Copeland Act and includes steps to be taken by departmental personnel and corrective actions for instances of non-compliance.

3. The department did not always comply with OMB Circular A-133 regarding the monitoring of subrecipients, increasing the risk of the department not detecting problems with subrecipients

Finding

The Department of Transportation (DOT) did not comply with certain Office of Management and Budget (OMB) Circular A-133 provisions regarding subrecipient monitoring for Federal-Aid Highway Program subrecipients. Specifically, we found that the department did not always notify the subrecipient of the applicable CFDA [*Catalog of Federal Domestic Assistance*] number, the department did not monitor all the subrecipients designated for monitoring by the department, and the department did not always ensure audits were performed of subrecipients as required.

OMB Circular A-133, Part 3, establishes requirements for the monitoring of subrecipients receiving federal monies from a pass-through entity. The circular states:

- *Award Identification* - At the time of the award, [identify] to the subrecipient the Federal award information (e.g., CFDA [*Catalog of Federal Domestic Assistance*] title and number, award name, name of Federal agency) and applicable compliance requirements.
- *During-the-Award Monitoring* - Monitoring the subrecipient's use of Federal awards through reporting, site visits, regular contact, or other means to provide reasonable assurance that the subrecipient administers Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- *Subrecipient Audits* - (1) Ensuring that subrecipients expending . . . \$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 9 months of the end of the subrecipient's audit period, (2) issuing a management decision on audit findings within 6 months after receipt of the subrecipient's audit report, and (3) ensuring that the subrecipient takes 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 shall take appropriate action using sanctions.

Department Did Not Notify Subrecipients of Applicable CFDA Number

We tested 63 Federal-Aid Highway Program subrecipients that were scheduled for monitoring by the Finance Division during the current audit period. Our testwork disclosed the following:

- For 53 of 63 subrecipients selected for testwork (84%), the responsible program staff did not notify subrecipients of the CFDA number in the award document as required by OMB Circular A-133. According to the Transportation Manager 2, personnel in the program sections were never advised that they should include the CFDA numbers in contracts.

Department Did Not Monitor All Subrecipients According To Its Monitoring Plan

To accomplish the objectives of award monitoring, the department developed a subrecipient monitoring plan which is used as the guidance for how the department's monitoring of subrecipients is to be conducted to ensure compliance with state and federal regulations. The department's plan states that ". . . the financial monitor manager selects the grantees to be monitored based on the 1/3 of the number of contracts and 2/3 of the dollar value of contracts . . ." The department's Audit Manager is responsible for selecting a sufficient number of subrecipients to be monitored both fiscally and programmatically on a yearly basis to comply with the one-third and two-thirds requirements. Our testwork on Federal-Aid Highway Program subrecipients disclosed the following:

- Sixteen of 53 subrecipients selected for monitoring by the department (30%) were not monitored. For fifteen of the 16 subrecipients, the department did not perform fiscal monitoring and did not perform programmatic monitoring for the remaining subrecipient. The department's Audit Manager stated the failure to monitor all designated subrecipients was due to a lack of personnel.

In addition, we could not determine whether the department followed its plan to monitor 1/3 of its contracts and 2/3 of the dollar value of contracts because of problems we found with the listing of subrecipient contracts used by the department to evaluate and select subrecipients for monitoring. We found that the listing of subrecipient contracts contained 19 contracts that were closed. Also, we determined that the listing of subrecipient contracts did not always have accurate information on subrecipients' expenditures for the fiscal year ended June 30, 2006. For four subrecipients, the listing showed no expenditures for the fiscal year, but we determined through a review of the accounting records that these four subrecipients had incurred expenditures ranging from \$2,273 to \$308,056.

Department Did Not Ensure Subrecipient Audits Were Properly Completed

We tested a listing of 132 subrecipients receiving Federal-Aid Highway Program federal funds to determine if department staff ensured audits were completed when an audit was required by OMB Circular A-133. Our testwork disclosed that:

- For 96 of 132 subrecipients tested (73%), the department's Audit Manager did not ensure audits were completed as required by OMB Circular A-133. The Audit Manager stated that he was not aware that the department was required to have a system in place to ensure these subrecipient audits were performed. The employee's supervisor was aware of the audit requirement and stated that subrecipients' audits are requested during the monitoring process. However, he acknowledged that the department does not have a process in place to ensure all required subrecipient audits are completed. Also, for one of the 96 subrecipients tested, we determined that independent auditors had disclosed a finding related to the Highway Planning and Construction program in their report, but there was no evidence that the department took any action regarding the finding. According to the DOT auditor assigned to that subrecipient, it is standard procedure for DOT auditors to review the most current independent audit reports during their monitoring reviews (During-the-Award monitoring) to determine whether these independent audit reports contained findings. Since the subrecipient was not monitored, the DOT auditor did not review the most current independent audit report. As a result, the DOT auditor did not know of the finding and did not take the action required by OMB Circular A-133. After we brought the subrecipient's audit finding to the DOT auditor's attention, the DOT auditor followed up by obtaining the subsequent independent audit report which disclosed that the finding was not repeated. We also reviewed the subsequent independent audit report and confirmed the finding was not repeated.

The Department of Transportation serves as a pass-through entity for the Federal-Aid Highway Program. At June 30, 2006, the department had outstanding contracts with subrecipients under this program for a total maximum liability in excess of \$130 million. Failing to follow the established monitoring plan, maintaining inaccurate listings of subrecipients, and not ensuring required subrecipient audits are completed increases the risk that problems including fraud, waste, abuse, and noncompliance by subrecipients will occur and not be detected in a timely manner by the department. In addition, proper notification of CFDA numbers is important to ensure subrecipients are aware of the sources of their funding and the related federal regulations.

Recommendation

The DOT Program Directors should ensure that the applicable CFDA number is included in all award documents for subrecipients. The department's Audit Manager should ensure that accurate and up-to-date information on subrecipients is maintained for use in the monitoring process. The Commissioner and Chief of Administration should ensure that a review of the current organizational structure and staffing over subrecipient monitoring is performed to determine whether the staff size and structure are adequate to properly monitor subrecipients and take the appropriate actions once a decision is reached. In addition, the Commissioner and Chief of Administration should ensure that policies and procedures are developed and implemented to ensure that subrecipient audits are completed as required and reviewed by departmental personnel. Department personnel should follow up with proper action for any reported findings. Management should include the risks noted in this finding in management's documented risk assessment.

The Commissioner should also ensure that other risks of improper accountability, noncompliance, fraud, waste, or abuse are adequately identified and assessed in management's documented risk assessment. Management should implement effective controls to ensure compliance with applicable requirements and assign staff to be responsible for ongoing monitoring of the risks and mitigating controls. Management should take appropriate action if deficiencies occur.

Management's Comment

We concur. Program areas in the department subject to subrecipient monitoring have adopted a standard CFDA reporting format to make sure grantees are notified of the CFDA number. The list of subrecipient contracts prepared by the program areas will be checked with the accounting records to ensure up-to-date information is used. A procedure will be developed so that the audited financial statements and reports of subrecipients will be reviewed and appropriate action will be taken for any reported findings.

- 4. The department incorrectly recorded the same capital assets in the accounting records in multiple years and has not updated its infrastructure policy to reflect current practice, increasing the risk of misstatements in the state's financial statements**

Finding

The Department of Transportation's finance office capitalized infrastructure asset amounts for the fiscal year ended June 30, 2006, which had already been capitalized in previous years. As a result, the department initially submitted an incorrect infrastructure schedule to the Department of Finance and Administration (F&A) for inclusion in the Tennessee Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2006. The department later submitted a revised schedule to F&A after the problems we identified were corrected. In addition, the department's current practice for the classification of infrastructure and construction in progress capital assets does not reflect current policy.

The department's finance office calculates "infrastructure and construction in progress capital asset amounts" for inclusion in the CAFR. The department uses the *Tennessee Department of Transportation, Guidelines for Reporting Infrastructure Assets*, which is derived from F&A's Position Paper 10, "GASB 34 Implementation – Reporting Infrastructure Assets," for determining when a capital asset should be classified as infrastructure or construction in progress. The guidelines state that "infrastructure assets are long-lived capital assets that usually are preserved for a greater number of years than most capital assets." The department defines its infrastructure assets to include roadways and bridges. The department computes "construction in progress" (CIP) by accumulating expenditures for a given project in a CIP account until the project is completed.

We tested all 78 projects exceeding \$1.3 million that were reclassified from CIP to infrastructure for the fiscal year ended June 30, 2006, to determine if the reclassification was

proper and in accordance with the department's guidelines. We found the following problems in our testwork:

- For 16 of 78 projects tested (20%) totaling \$132,041,949, projects were reclassified to infrastructure after they had already been added to infrastructure in prior years, overstating the infrastructure amount initially reported to F&A. These errors primarily occurred because department staff incurred additional costs for projects that had already been reclassified as infrastructure. Although a project may be substantially complete, incidental costs, such as landscaping fees, may still be incurred. However, instead of capitalizing only the additional costs incurred during the current fiscal year, the entire cost of the project was capitalized again. The infrastructure total was subsequently corrected by the department.
- For one of 78 projects tested (1%), the project was erroneously reclassified from CIP to infrastructure. This error resulted in a \$10,084,588 addition to infrastructure in the fiscal year ended June 30, 2006. The project was subsequently placed back into CIP.
- For 32 of 78 projects tested (41%), the finance office did not follow their own guidelines when reclassifying CIP to infrastructure. The department's guidelines require that a project's cost be reclassified from CIP to infrastructure after a completion notice for a project is issued by the department's engineers and sent to the department's fiscal office. For 14 of the projects totaling \$122,527,687, the completion date on the completion notice was prior to the fiscal year ended June 30, 2006; therefore, 14 projects should have been reclassified to infrastructure in prior fiscal years but were instead reclassified to infrastructure in fiscal year 2006. For 9 of the projects totaling \$118,774,358, the completion date according to the completion notice was in the fiscal year ending June 30, 2007, but the finance office reclassified the project to infrastructure in the fiscal year ended June 30, 2006. For the remaining 9 projects totaling \$197,072,148, the finance office did not have completion notices on file, but the projects were reclassified to infrastructure anyway. As discussed below, we ultimately agreed with the department's decision to reclassify these projects as infrastructure; however, management did not follow its guidelines.

Based on discussions with the Director of Finance, the discrepancies noted in the reclassification of projects from CIP to infrastructure occurred because the department's actual practice is to reclassify a project as infrastructure when the project is substantially complete and traffic is flowing. According to the Director of Finance, the problem with using the completion notices as evidence of a project's completion is that there are often long delays between when a project has been completed and when the completion notice is received by the finance office. In addition, the director disclosed that the finance office uses inquiries of departmental employees in the regional offices and an examination of the fiscal records to determine when a project has been completed and traffic is flowing. We agree that the department's current practice is appropriate since the completion notices have not proved to be a reliable tool. For the 18 projects where a completion notice was not received in the finance office by June 30, 2006, we reviewed each project's status with staff in the finance office and agreed that the project was

completed and should have been reclassified as infrastructure. However, the department has not changed its guidelines to reflect this current practice.

We also tested all 93 projects exceeding \$1.4 million that were still classified as CIP for the fiscal year ended June 30, 2006, to determine if the classification was proper. Specifically, we analyzed each of these 93 projects in CIP to determine whether the project was still in progress or whether the project was substantially complete with traffic flowing.

We found the following problems in our testwork:

- For 3 of 93 projects tested (3%) totaling \$31,181,349, there was sufficient evidence that the projects were completed and should have been reclassified from CIP to infrastructure. The department overlooked these three projects during the reclassification process, but subsequently reclassified these 3 projects as infrastructure when we informed them of the problem.

The Department of Transportation reported approximately \$17.8 billion in infrastructure capital assets and \$1.2 billion in construction in progress capital assets that were included in the state's financial statements for the fiscal year ended June 30, 2006. It is important that the department's guidelines reflect actual practice to ensure all fiscal personnel have a clear understanding of asset classification criteria. Without up-to-date policies and proper procedures including determining when a project has already been reclassified from CIP to infrastructure, there is an increased risk of misstatements occurring in the state's financial statements.

Recommendation

The Commissioner and Director of Finance should revise the *Tennessee Department of Transportation, Guidelines for Reporting Infrastructure Assets* to reflect the current practice of reclassifying assets from construction in progress to infrastructure based on when assets are substantially complete and traffic is flowing. The Director of Finance should consult the appropriate personnel with the Division of Accounts at F&A so any necessary changes can be made to F&A Position Paper 10 which also contains guidelines for the classification of infrastructure and construction in progress. In addition, the Director of Finance and staff should perform an analysis of the problems identified in this audit regarding the computation of infrastructure and construction in progress and consider if additional procedures are necessary to ensure capital assets are classified in a consistent manner and not recorded in the financial statements more than once. Management should include the risks noted in this finding in management's documented risk assessment.

The Commissioner should also ensure that other risks of improper accountability, noncompliance, fraud, waste, or abuse are adequately identified and assessed in management's documented risk assessment. Management should implement effective controls to ensure compliance with applicable requirements and assign staff to be responsible for ongoing monitoring of the risks and mitigating controls. Management should take appropriate action if deficiencies occur.

Management's Comment

We concur. The department's *Guidelines for Reporting Infrastructure Assets* have been revised to reflect the current practice of reclassifying assets from construction in progress to infrastructure based on when assets are substantially complete and traffic is flowing. In addition, Finance and Administration (F&A) has been contacted concerning changes appropriate for Position Paper 10, *GASB 34 Implementation, Reporting Infrastructure Assets*.

On November 3, 2006, a change request to the Office for Information Resources was initiated to update TDOT STARS. This change request will add six additional edits to the TDOT STARS accounting system to ensure capital assets are not recorded in the financial statements more than once.

STATUS OF PRIOR AUDIT FINDINGS

State of Tennessee Single Audit Report for the year ended June 30, 2005

Audit findings pertaining to the Department of Transportation were included in the *Single Audit Report*. The updated status of these findings as determined by our audit procedures is described below.

Resolved Audit Finding

The current audit disclosed that the Department of Transportation has corrected the previous audit finding concerning the adherence to departmental policies and procedures regarding the Davis-Bacon Act.

Repeated Audit Finding

The current audit disclosed that the Department of Transportation has not corrected the previous audit finding concerning compliance with the Copeland Act. This finding will be repeated in the *Single Audit Report* for the year ended June 30, 2006.

Most Recent Financial and Compliance Audit

Audit report number 06/036 for the Department of Transportation, issued in February 2007, contained certain audit findings that were not included in the State of Tennessee *Single Audit Report*. These findings were not relevant to our current audit and, as a result, we did not pursue their status as a part of this audit.

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 commissioner.

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.