AUDIT REPORT

Department of Tourist Development

February 2009

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Tennessee Comptroller of the Treasury

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February 5, 2009

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Susan H. Whitaker, Commissioner
Department of Tourist Development
Tennessee Tower, 25th Floor
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Tourist Development for the period March 1, 2004, through May 31, 2007. We also conducted a separate special investigation of certain purchasing activities.

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 Department of Tourist Development's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Department of Tourist Development 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 a finding which is detailed in the Objectives, Methodologies, and Conclusions section of this report, and our special investigation disclosed a finding which is detailed in the Special Investigation section. The department's management has responded to the 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 findings.

We have reported other less significant matters involving the department's internal control and instances of noncompliance to the Department of Tourist Development's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr.

Arthur A. Hayes, Jr., CPA
Director

AAH/ajm
07/098

State of Tennessee

Audit Highlights

Comptroller of the Treasury Division of State Audit

Financial and Compliance Audit
Department of Tourist Development
February 2009

AUDIT SCOPE

We have audited the Department of Tourist Development for the period March 1, 2004, through May 31, 2007. 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, equipment, grants, revenue, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. We also conducted a separate special investigation of certain purchasing activities.

AUDIT FINDING

Management Has Not Adequately Assessed and Mitigated the Risks Associated With Inadequate Controls Over Cash Receipting, and as a Result, Controls Over Cash Receipts Are Weak, Thus Increasing the Risks of Fraud, Waste, and Abuse*
Cash-receipting duties were not adequately segregated. Staff did not perform reconciliations between cash receipts, accounting records, and deposits. Staff receiving funds did not immediately prepare cash receipts (page 7).

SPECIAL INVESTIGATION

Significant Weaknesses in Internal Controls Made the Department Vulnerable to Fraudulent Purchases
According to the maintenance supervisor of the 13 welcome centers for the Tennessee Department of Tourist Development, he colluded with a sales representative and the manager from a local supply company to charge items to the state that were actually for his personal use. The matter was discovered after the supply company changed owners in July 2005. We found that the maintenance supervisor misappropriated a total of $6,185.74 for his personal use by misrepresenting personal purchases as valid purchases. This amount includes 19 invoices and 2 checks. The maintenance supervisor was terminated on April 17, 2006 (page 11).

* This finding is repeated from the prior audit.

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INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Tourist Development. 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 Department of Tourist Development is to create and promote the desire to travel to and within Tennessee; to develop programs to encourage and support the growth of the state's tourism industry; and to manage a system of welcome centers that provides visitors with a positive impression of Tennessee and encourages them to extend their stay, all of which contribute to the state's economic growth, thereby enriching the quality of life for every Tennessean. In order to fulfill this mission, the department has three major operating divisions: Marketing, Community and Industry Relations, and Administration (which includes the Welcome Centers).

The Marketing Division responsibilities include the development of a tourism advertising campaign; managing the placement of print and broadcast media to produce the greatest return on investment; participating in state, national, and international tourism trade shows and consumer travel shows; producing the annual *Tennessee Vacation Guide*, maps, events brochures, and other promotional literature that is distributed to consumers; managing a Tennessee news bureau that takes story ideas from the state's tourism industry and writes travel articles that are distributed to the media; managing the tourism website TnVacation.com that has become the major marketing tool for consumers to find travel information; planning and organizing travel writer trips to Tennessee in an effort to increase press coverage of Tennessee in major publications; and coordinating with the travel industry on joint marketing projects.

The Community and Industry Relations Division staff works directly with communities, attractions, and tourism associations and groups across the state to encourage and promote the economic benefits of tourism and provide advice on the services available from the department that may provide assistance. The division plans and coordinates tourism events and programs that benefit the tourism industry.

The Administration Division oversees the fiscal operations, human resources, payroll, procurement services, contract administration, support services including information systems and facility management, telemarketing and fulfillment services, postal services, and other services necessary for the operations of the department. In addition, the division oversees the operations of the department's 13 welcome centers that serve as the contact point for visitors entering Tennessee, providing information about attractions and other vacation opportunities in Tennessee. The centers also assist visitors with reservations for lodging. Most welcome centers are open 24 hours per day, 7 days a week, serving over 14 million visitors each year.

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

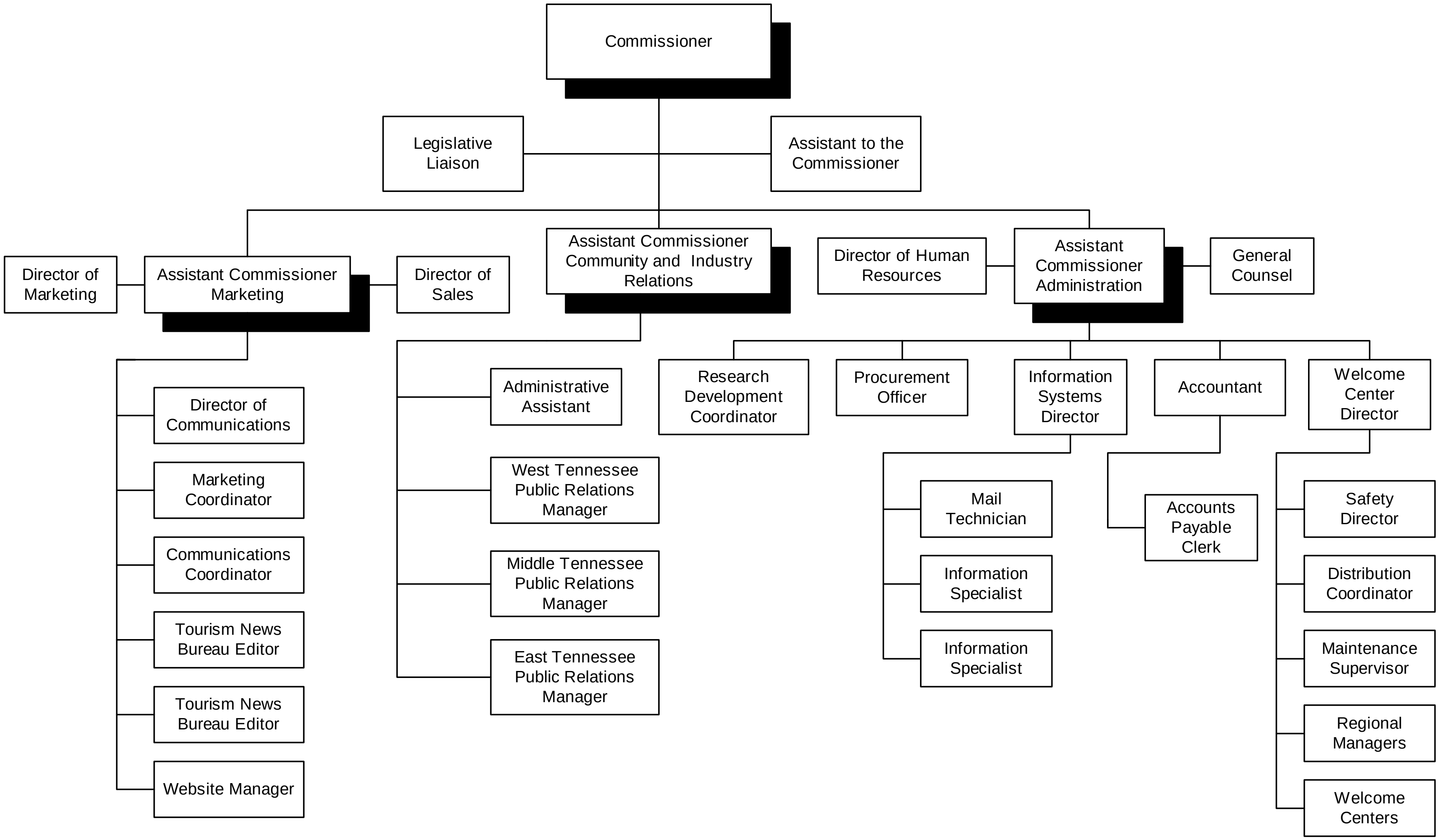
AUDIT SCOPE

We have audited the Department of Tourist Development for the period March 1, 2004, through May 31, 2007. 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, equipment, grants, revenue, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. We also conducted a separate special investigation of certain purchasing activities.

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 Department of Tourist Development filed its report with the Department of Audit on November 18, 2004. A follow-up of all prior audit findings was conducted as part of the current audit.

Department of Tourist Development
Organization Chart



Resolved Audit Finding

The current audit disclosed that the Department of Tourist Development has corrected the previous audit finding concerning controls over expenditures needing improvement.

Repeated Audit Finding

The prior audit report contained a finding concerning weak controls over cash receipts. The finding has not been resolved and is repeated in the applicable section of this report.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

Expenditures

The objectives of our review of expenditure controls and procedures were to determine whether

- purchasing duties were adequately segregated;
- expenditures for goods or services were adequately supported, properly authorized, and correctly recorded in the state's accounting system;
- expenditures were in compliance with applicable state requirements;
- payments to vendors were made promptly;
- contract payments complied with contract terms and purchasing guidelines;
- voucher registers were properly approved; and
- reports received from the Department of Finance and Administration were reconciled with the department's records.

We interviewed key personnel to gain an understanding of the department's procedures and controls over expenditures. We then selected nonstatistical samples of expenditure transactions to determine if expenditures were adequately supported, properly authorized, correctly recorded, paid timely, and processed in accordance with the applicable state requirements and contract terms. We also reviewed some of the voucher registers processed during the audit period for approval and inspected some of the related monthly reconciliations.

Based on our testwork, we determined that expenditures for goods and services were adequately supported and correctly recorded and that contract payments complied with contract terms and purchasing guidelines. We determined that voucher registers were properly approved and that the department reconciled its records with reports received from the Department of Finance and Administration. We determined that segregation of duties related to purchasing was weak; however, because of the size of the department, we felt that compensating controls mitigated the weakness. In most cases, expenditures were properly authorized, paid timely, and made in accordance with applicable state requirements.

EQUIPMENT

The objectives of our review of equipment controls and procedures were to determine whether

- the information on the department's equipment listed in the Property of the State of Tennessee (POST) system was accurate and complete;
- property and equipment were adequately safeguarded;
- equipment purchased during the audit period was properly recorded in POST; and
- vehicles including other motorized equipment and equipment leased by the department could be located.

We interviewed key personnel to gain an understanding of the department's procedures and controls for safeguarding and accounting for equipment. We also reviewed the annual equipment inventory administered by the department's property officer in conjunction with our evaluation of physical security procedures. We reviewed supporting documentation and tested a nonstatistical sample of equipment items from the POST system. Equipment items were physically located or confirmed, and description, tag number, serial number, and location were agreed to the POST listing. For items that were purchased during the audit period, the cost recorded in POST was traced to supporting documentation. In addition, we obtained the most current listing of vehicles and other equipment leased by the department. We physically located or confirmed all vehicles including other motorized equipment.

Based on interviews, review of supporting documentation, and testwork, we determined that the information in POST is accurate and complete; property and equipment were adequately safeguarded; and equipment purchased during the audit period was properly recorded in POST. In addition, leased vehicles and other equipment were physically located or confirmed.

GRANTS

The objectives of our review of grants were to determine whether

- grant expenditures were properly approved, adequately supported, and correctly recorded;
- grant expenditures exceeded authorized amounts;

- the grantees’ matching portions were in compliance with the grant agreements;
- grant agreements were properly approved; and
- the information required by the department’s rules had been received from the grantees.

We interviewed key personnel and reviewed the program guidelines to gain an understanding of the department’s procedures and controls over grants. We tested a nonstatistical sample of grant expenditures for the period March 1, 2004, through March 31, 2007, to determine whether expenditures were properly approved, adequately supported, and correctly recorded; and to determine whether grant expenditures exceeded authorized amounts. We reviewed supporting documentation to determine whether the grantees’ matching portions complied with the grant agreements. We also reviewed the related grant folders to determine whether the grant agreements had been properly approved and whether the required information was included.

Based on our interviews, testwork, and reviews of supporting documentation, we concluded that grant expenditures were properly approved, adequately supported with an exception, and correctly recorded; grant expenditures did not exceed authorized amounts; the grantees’ matching portions were in compliance with the grant agreements; the grant agreements had been properly approved with minor exceptions; and the information required by the department’s rules had been received from the grantees with minor exceptions.

REVENUE

The objectives of our review of revenue internal controls and procedures were to determine whether

- revenue was correctly recorded;
- the department reconciled its records with the revenue reports issued by the Department of Finance and Administration (F&A);
- prenumbered receipts were issued in sequence for all monies received, and copies of voided receipts were retained;
- receipts were deposited in a timely manner; and
- receipts agreed with amounts deposited.

We interviewed key personnel to gain an understanding of the department’s procedures and controls over revenue. We examined the reconciliation of the department’s records with the revenue reports issued by F&A. We tested a nonstatistical sample of prenumbered receipts for the period March 1, 2004, through March 31, 2007, for propriety. We also tested a nonstatistical sample of revenue transactions for the period March 1, 2004, through March 31, 2007, to determine if revenue was properly recorded.

Based on our interviews, reviews of supporting documentation, and testwork, we concluded that the department's monthly reconciliations of its records to revenue reports issued by F&A were proper. We also determined that prenumbered receipts had been issued in sequence and that receipts agreed with amounts deposited. However, our testwork revealed that controls over revenue were not adequate and timeliness of deposits could not be determined. These issues are discussed in finding 1.

1. <u>Management has not adequately assessed and mitigated the risks associated with inadequate controls over cash receipting, and as a result, controls over cash receipts are weak, thus increasing the risks of fraud, waste, and abuse</u>

Finding

The Department of Tourist Development receives checks by mail throughout the year for various events such as conferences and banquets. These events are sponsored by the department to promote tourism in Tennessee. In the prior audit report, it was noted that voided receipts were discarded in error rather than being kept. Since the prior audit, the accounts payable clerk ensured that voided receipts were kept rather than discarded and receipts were recorded in the correct accounts. However, the department's other critical controls over these receipts were still weak. Testwork revealed the following problems:

- Cash-receipting duties were not adequately segregated. The accountant prepared the deposits, made the deposits in the bank, and posted the deposits to the accounting records.
- There was no reconciliation between the cash receipts and the deposits or with the cash receipts and the accounting records.
- The accounts payable clerk did not immediately prepare cash receipts upon receipt of the funds. Mail containing checks was opened, but receipts were not written immediately. Instead, receipts were written close to the day the funds were deposited. As a result, we could not determine whether deposits were made timely.

Section 9-4-301, *Tennessee Code Annotated,* states that

> it is the duty of every department, institution, office and agency of the state and every officer and employee of state government, including the state treasurer, collecting or receiving state funds, to deposit them immediately into the treasury or to the account of the state treasurer in a bank designated as a state depository or to the appropriate departmental account if authorized by §9-4-302.

In the prior audit report, management stated that the department would develop internal controls to segregate responsibilities or establish compensating controls necessary for the proper receipting, depositing, and reconciliation of funds. However, since management had not yet taken the necessary steps to resolve this issue, the cash-receipting duties were still not adequately segregated; the reconciliation of cash receipts to deposits, or cash receipts to accounting records, was not performed; and cash receipts were still not written immediately upon receipt of funds. Per discussion with the Assistant Commissioner of Administration, he concurred that cash-receipting duty segregation is still a problem, mostly due to the small size of the staff, but he concurred that compensating controls should be improved. In addition, he stated that the prior accountant was not able to make the deposits in a timely manner. This was due to a personal issue, but he was unaware that it was a continuing problem with the current staff and concurred that it should be addressed immediately.

Because the department's management has not monitored controls over cash receipting and mitigated risks by adequately segregating duties for preparing the deposit, making the deposit in the bank, and posting to the accounting records, there is no way to know that all the money received was deposited. The accountant could easily steal part of the deposit and record the funds as if they were received. Furthermore, without proper reconciliations of cash collected, deposited, and recorded, this type of fraud could occur and go undetected. Also, since deposits are not being made in a timely manner, this increases the risk of fraud in the deposits being misplaced or mishandled.

Effective internal controls are essential to account for government resources and to ensure that revenue is properly accounted for. Management has the responsibility to establish control procedures that will ensure funds received are properly accounted for and to provide effective supervisory reviews that provide reasonable assurance of preventing or detecting errors and fraud.

Recommendation

The Commissioner should perform risk assessments to identify all risks and controls associated with the cash-receipting function. The Commissioner should ensure staff immediately design and implement effective internal controls to segregate responsibilities. The individual preparing the deposit should not be the same person that makes the deposit and posts to the accounting records. Management should also ensure that monthly reconciliations are performed between cash receipts and deposits and between cash receipts and accounting records. This should be performed by the Assistant Commissioner of Administration. Also, management should ensure all incoming funds are receipted immediately as the mail is opened to ensure proper documentation of receipt. Employees should be monitored to ensure compliance with established procedures, and actions should be taken when exceptions are noted.

While segregating duties can be difficult for small departments, if duties cannot be effectively segregated, management should immediately develop procedures to adequately monitor the receipting, depositing, and posting of revenue as a compensating control. Monitoring individuals in the department would be the responsibility of the Assistant Commissioner of Administration. The monitoring by the Assistant Commissioner of Administration should be documented, and actions should be taken when exceptions are noted.

Management should ensure that the risks 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 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. A risk assessment to identify all risks and controls associated with the cash-receipting function has been performed. The following process to adequately segregate duties and reconcile cash receipts, deposits, and accounting records has been recommended. Checks will be stamped and receipted the day they are received by someone other than the accounting manager. After being receipted, the checks are given to the accounting manager, who prepares the deposit slip. The person who receipted the checks will initial the deposit slip to verify that all checks receipted are included on the deposit slip. The deposit slip is reviewed and signed by the Assistant Commissioner of Administration. The accounting manager will make the deposit and give a copy of the bank receipt and deposit slip to our accounts payable clerk. The accounts payable clerk will sign the receipt verifying that the receipt matched the deposit. The accounts payable clerk will enter the information in the state's financial system. The Assistant Commissioner of Administration will monitor this process.

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 objective was to determine whether the department's June 30, 2006; June 30, 2005; and June 30, 2004, responsibility letters were filed in compliance with Section 9-18-104, *Tennessee Code Annotated.*

We reviewed the June 30, 2006; June 30, 2005; and June 30, 2004, responsibility letters submitted to the Comptroller of the Treasury and the Department of Finance and Administration to determine adherence to the submission deadline. We determined that the Financial Integrity Act responsibility letters were submitted late for each of the fiscal years, 299 days, 166 days, and 168 days late, respectively. Management indicated that they had apparently confused the two deadlines and thought the responsibility letter was due December 31 instead of June 30.

SPECIAL INVESTIGATION

Origin of the Review

In February 2006, Mr. Steve Lentchner, the owner of Nashville Supply House (hereinafter referred to as NSH), and his attorney provided information in Nashville, Tennessee, to staff of the Division of State Audit relating to a state employee who apparently had colluded with the former owner of NSH and at least two NSH employees to purchase items from the supply company for his personal use. The matter was discovered after NSH changed owners in July 2005. The state employee in question, Mr. Kennard Jones, was a maintenance supervisor with the Department of Tourist Development.

Objectives of the Review

The objectives of this review were

- to determine the nature and extent of possible abuse of purchases by Mr. Jones;
- to obtain Mr. Jones' explanation for his purchases;
- to determine the adequacy of related internal controls;
- to report any findings to the appropriate authorities; and
- to recommend appropriate actions to correct any noted deficiencies.

Scope of the Review

During the review, we interviewed Mr. Jones as well as NSH staff and Tourist Development staff. We also reviewed purchases for the period March 2005 to March 2007 and obtained additional information from Mr. Lentchner.

Background

Mr. Lentchner purchased Nashville Supply House in July 2005. In the course of familiarizing himself with the business, Mr. Lentchner reviewed invoices and discussed billing procedures with his bookkeeper. During his review, he noticed that an invoice sent to the state specified certain items, but attached to the supply company's copy of the invoice, for only the supply company to see, were invoices from other companies for entirely different items. The details of our review are noted in finding 2.

2. Significant weaknesses in internal controls made the department vulnerable to fraudulent purchases

Finding

The use of a well-controlled purchasing program is a necessary tool in streamlining the state's acquisition processes and providing agencies flexibility to make small and routine purchases. Stringent controls within a purchasing program ensure charges are reasonable, in accordance with organizational policies, and properly recorded. However, we found ineffective management oversight and internal control over purchasing. A weak overall control environment and subsequent breakdowns in internal control left the department vulnerable to fraudulent and improper purchases.

According to Mr. Kennard Jones, the maintenance supervisor (hereinafter referred to as maintenance supervisor) of the 13 welcome centers for the Tennessee Department of Tourist Development, he colluded with a sales representative and the manager from a local supply company to charge items to the state that were actually for his personal use. The matter was discovered after the supply company changed owners in July 2005.

We found that the maintenance supervisor misappropriated a total of $6,185.74 for his personal use by misrepresenting personal purchases as valid purchases. This amount includes 19 invoices and 2 checks. The maintenance supervisor was terminated on April 17, 2006.

In the course of familiarizing himself with the business, the new owner reviewed invoices. During his review, he noticed that an invoice sent to the state specified certain items, but attached to the company's copy of the invoice, for only the company to see, were invoices from other companies for entirely different items. For example, an invoice sent to the state listed a purchase of a "surge protector and 9585/5," but the actual items purchased were nine five-gallon containers of paint. The total amounts agreed. Additionally, we noted that the former owner added significant markups for providing its services, resulting in an increase in the price to the state of up to 60% of the purchase price.

On February 10, 2006, an attorney representing the new owner of the supply company reported the matter to our office, and we began our review of the matter. The maintenance supervisor was terminated from employment when he admitted to us that some of the items purchased were for his personal use. Items that he purchased for his personal use included paint and tools. During our interview with the maintenance supervisor, he also admitted that he bought some items for his work but falsified the items' description in order to circumvent the approval process, thereby preventing anyone from questioning the purchases. For example, he purchased a set of fog lights and a CB radio and radio antenna for his work truck, but he coded the items as a "fixture" for a welcome center in order to avoid having to obtain approval for purchasing the items. The total amount for these items was $263.60. The maintenance supervisor stated that although he did not seek approval from management for the items, he knew that management would not approve the items so he purchased them and coded them as an item he would use during his normal course of work. According to department management staff, they would not have approved the purchase of these items. The maintenance supervisor had been authorized to purchase up to $400 in maintenance related items without any subsequent review.

Additionally, after the maintenance supervisor was terminated on April 17, 2006, the department began its own review to determine whether he had misappropriated other items he claimed to have bought for the welcome centers. The department found that many items listed as being purchased for the welcome centers could not be located at the welcome centers or verified by the welcome center managers as having been purchased for and delivered to the welcome centers.

We reviewed invoices from the supply company obtained from the new owner and the department. The following types of internal control problems were identified during our review:

- lack of segregation of duties;
- lack of documentation/inadequate documentation of purchases; and
- inadequate supervisory review of purchases.

Each of these areas is discussed in more detail below.

Lack of segregation of duties

The Department of Tourist Development had weak internal controls due to lack of segregation of duties. The maintenance supervisor was responsible for identifying what items were needed at the welcome centers, ordering the items, purchasing the items using purchase orders, picking the items up from the supply company, approving purchases that were under $400 in total, and entering the purchases into the Tennessee On-line Purchasing System (TOPS). There was no oversight of the maintenance supervisor in place for purchases under the $400 threshold at the time of our review.

Prudent business practices suggest that approving officials be sufficiently independent and of sufficient rank to question the purchasing staff when additional information is needed about specific transactions. Approving officials should also have firsthand knowledge of the type of products and services purchased. Additionally, all persons, regardless of their position, should have someone else reviewing and/or approving their purchases. The approver should have a position of authority over the purchaser.

Lack of documentation/inadequate documentation of purchases

During our review, we found that a significant percentage of invoice files lacked documentation supporting or explaining purchases. The documentation should clearly identify what was purchased, from where, and by whom; however, we noted that the invoices that were submitted only showed the total expenditure and failed to clearly identify what was purchased. The following examples provide details of some of the problems we identified.

- The maintenance supervisor admitted that he had bought paint for his personal painting business using the state's purchasing process. The maintenance supervisor admitted that rather than writing "paint" on the invoice, he instructed the supply company employee to enter a series of numbers and letters in order to disguise the purchase. The maintenance supervisor stated that he did this on several occasions to support his painting business. Because the invoice submitted by the maintenance supervisor to the department's fiscal office for payment contained only numbers and letters in the "item description" column, it would have been impossible for a reviewer or approver, if there had been one, to determine the exact nature of the items being purchased.

- The maintenance supervisor purchased a CB radio and radio antenna, and fog lights for his state truck, but he had the supply company employee disguise the items as a "fixture." The maintenance supervisor also stated that he coded the items on TOPS as something other than the actual purchases in order to prevent possible questions about the items. The maintenance supervisor returned the items to the department after he had been terminated.

- The maintenance supervisor purchased speaker boxes and speakers that are usually installed in private homes to relay music throughout rooms. The maintenance supervisor stated that he had used the speakers at a welcome center. However, when we contacted the welcome center management, they stated that at no time did the maintenance supervisor install speakers in the welcome center. The maintenance supervisor returned the speaker boxes and speakers to the department after he had been terminated.

- The maintenance supervisor also purchased other items through purchase orders that he claimed were used at welcome centers such as kitchen sinks, ice makers for refrigerators, tool boxes, and a pressure washer motor. However, as with the speakers and speaker boxes, no welcome center management had knowledge of any of the items being bought for or installed at the welcome centers. The maintenance supervisor returned the items to the department after he had been terminated.

<u>Inadequate supervisory review of purchases</u>

During the interview with the maintenance supervisor, he stated that he was not required to get approval from management before making purchases under $400 and was not required to provide an explanation for the purchases. The maintenance supervisor explained that because there was no supervisory review, he was able to conceal his thefts. Of the 70 invoices we reviewed, only one invoice was over $400. That invoice totaled $2,189 for the purchase of a Parker 8 HP Kohler motor. Although that invoice was over $400, it did not have a second signature on the copy we obtained. During our review, the director of welcome centers verified that the purchase of the motor was legitimate by reviewing the invoice and the motor with the welcome center manager.

- The maintenance supervisor stated that he was able to facilitate this activity because there was no oversight over his purchases that were under $400. He stated that because there was no segregation of duties, he was able to facilitate the misappropriations without anyone from the department knowing what he was doing. It was only when the supply company was sold to another person and that person noticed inconsistencies that the activity was caught.

- Additionally, during our review, the new owner of the supply company discovered that at least two checks totaling $600.69, written in April and October 2004, according to the supply company's disbursements journal, were issued to the maintenance supervisor by the supply company believed to be for the return of items purchased using the state purchasing system. The maintenance supervisor stated that the checks were written to him in repayment for items which he had bought for the welcome centers using his personal funds. The maintenance supervisor stated that after he bought items for the welcome centers from a vendor other than the supply company, he took the receipts to an employee of the supply company and the two colluded to create invoices showing that the items were purchased through the supply company. However, the maintenance supervisor could not provide any copies of the receipts or describe the items he purportedly purchased with his personal funds.

On December 12, 2007, the maintenance supervisor entered a guilty plea in the Davidson County Criminal Court to one count of Theft of Property. The maintenance supervisor was sentenced to two years in a CCA workhouse, but the jail sentence was suspended and the maintenance supervisor was placed on supervised probation. The maintenance supervisor was also required to repay $2,310.54, in restitution to the department and court costs. The repayment was made on December 13, 2007, for the ordered restitution amount. According to the district attorney's office staff, although we found that the maintenance supervisor misappropriated a more significant amount, he was only required to repay the amount he confessed to during their review.

Management and staff of the department cooperated fully with the review and responded in a timely manner to all information requests. Internal controls over welcome centers at the department have been strengthened since the discovery of the maintenance supervisor's improper actions. Specifically, the department has transferred the duty of authorizing purchases from the new maintenance supervisor to the welcome center managers. If a needed item is not available in a particular area or if the welcome center manager is not available, the purchasing officer for the department makes the purchase. Additionally, the welcome center managers are only allowed to make local purchases up to $100 without prior approval. For purchases ranging from $101 to $500, the welcome center managers must get approval from their regional manager. Purchases totaling $501 and higher must be approved by the director of welcome centers. The department believes that this new purchasing method will help in controlling spending, keep everyone involved more accountable, and help the welcome center director keep track of the budget by keeping better records of what funds are being used for and at what welcome center.

Recommendation

Although state agencies' use of purchase orders provides significant benefits to the state, the department should improve its oversight to provide reasonable assurance that adequate internal controls against fraudulent and improper purchases are implemented. These adequate internals controls should include the following:

- The department must ensure that the duties surrounding purchasing are adequately segregated. The purchasing procedures should detail that all conflicting duties related to purchasing transactions are appropriately assigned to separate individuals. Management over the welcome center area should periodically review responsibilities to ensure that the correct individuals are performing their assigned task. Any discrepancies should be thoroughly investigated.
- The department should routinely review detailed electronic purchasing data to help identify mismanagement and potential fraud and abuse.
- The department should require documentation of purchases to be provided by purchasing staff and reviewed by approving officials. Such documentation should include receipts detailing the items purchased, proof of delivery/receipt when items have been ordered, and inventory numbers, if appropriate.
- The department should ensure appropriate job responsibilities of approving officials. Department management should require that approving officials be sufficiently independent and of sufficient rank to question the purchasing staff when additional information is needed about specific transactions. Approving officials should also have firsthand knowledge of the type of products and services purchased by the employee.
- The department should require training programs for both purchasing staff and approving officials.

Management's Comment

We concur. A risk assessment to identify risks and controls associated with the purchasing process for the statewide maintenance supervisor in the welcome center division has been performed. As a result of that assessment, it has been determined that whoever performs that function will no longer be authorized to make purchases. Any maintenance item needed will now be procured by management at the appropriate welcome center using the purchasing process established for welcome center operations. The welcome center director may also process procurement requests as needed for statewide maintenance directly through the central procurement office. The statewide maintenance supervisor is no longer permitted to make purchases.

In addition to the risk assessment made regarding the statewide maintenance function, an assessment of the internal controls for the welcome center division's procurement processes was also conducted. Although there were adequate controls identified, the director has implemented new spending limits and has strengthened the review and approval process for all welcome center purchases. Specifically, the welcome center managers are only allowed to make local purchases up to $100 without prior approval. For purchases $101 to $500, the welcome center managers must get approval from their regional manager. Purchases totaling $501 and higher must be approved by the director of welcome centers.

The changes to the internal controls in the Welcome Center Division have already been implemented.

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, *Consideration of Fraud in a Financial Statement Audit*, promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, 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.

APPENDIX

ALLOTMENT CODES

326.01 Administration and Marketing

326.03 Welcome Centers