Audit Results From
CAFR and Single Audit Procedures

Department of Transportation

For the Year Ended
June 30, 2007

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, 2007

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Department of Transportation
For the Year Ended June 30, 2007

EXECUTIVE SUMMARY

Findings

FINDING 1 As noted in the prior audit, the Department of Transportation has still not fully developed and implemented 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 As stated in the prior audit, the department did not always comply with OMB Circular A-133 regarding the monitoring of subrecipients, increasing the risk of the department not detecting fraud, waste, abuse, and noncompliance problems with subrecipients (page 9).

FINDING 3 The controls over the Formula Grants For Other Than Urbanized Areas program were weak, increasing the risks of the improper use of funds and the misappropriation of vehicles (page 11).

This report addresses significant deficiencies 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, 2007, and the State of Tennessee *Single Audit Report* for the Year Ended June 30, 2007. The scope of our audit procedures at the Department of Transportation was limited. During the audit for the year ended June 30, 2007, our work at the Department of Transportation focused on two major federal programs: Highway Planning and Construction and Formula Grants For Other Than Urbanized Areas. We audited these federally funded programs to determine whether the department complied with certain federal requirements and whether the department had an adequate system of internal control over the programs 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 29, 2008

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, 2007, 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,

John G. Morgan
Comptroller of the Treasury

JGM/ddm
07/106

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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December 7, 2007

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, 2007. 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 programs administered by the Department of Transportation. We performed certain audit procedures on these programs 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 Programs Administered by the Department of Transportation For the Year Ended June 30, 2007 (in thousands)

CFDA Number	Program Name	Federal Disbursements
20.205	Highway Planning and Construction	$742,503
20.509	Formula Grants For Other Than Urbanized Areas	$8,747

Source: State of Tennessee's Schedule of Expenditures of Federal Awards for the year ended June 30, 2007.

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 7, 2007, on the State of Tennessee's financial statements for the year ended June 30, 2007. 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 programs 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,

Arthur A. Hayes, Jr., CPA
Director

AAH/ddm

FINDINGS AND RECOMMENDATIONS

1. <u>As noted in the prior audit, the Department of Transportation has still not fully developed and implemented 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</u>

Finding

In the prior audit, we noted that 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. The department's management concurred with the prior audit finding. In response to the prior year finding, the department has worked on a disaster recovery plan, but the plan has not been fully implemented. As discussed below, the department in conjunction with OIR is in the process of "migrating" its application systems to the state's data center.

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 Tennessee Overweight/Overdimensional Permit System (TOOPS); Tennessee Roadway Information Management System (TRIMS); 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:

- TOOPS – Section 55-7-205, *Tennessee Code Annotated*, requires the Tennessee Department of Transportation to issue special permits for the movements of freight motor vehicles carrying gross weights or having dimensions in excess of normal legal limits. *Tennessee Code Annotated* also requires the collection of a permit fee to cover the administrative costs of issuing these permits. The TOOPS system aids in the issuance of these permits and the collection of the resulting fees.

- TRIMS – TRIMS is critical in determining the needs and funding for Local Governments, Highway Safety, Local and State Bridge Replacement Programs, Federal Interstate Maintenance funds, and Highway Needs Analysis, as well as many other systems within the department. TRIMS interfaces/integrates with the department's Pavement Management System, Maintenance Management System, Advanced Traffic Data Analysis Management (ADAM), Evaluation of Roadway Efficiency (EVE), Highway Performance Monitor System (HPMS), and Crash High Hazard Elimination Program. Additionally, TRIMS provides data and access to the following users outside of the department: the Attorney General's Office, the Tennessee Emergency Management Agency, the Federal Highway Administration,

the Department of Safety, the Department of Health, the Office of Homeland Security, County and City Roadway Agencies, universities, and other local government agencies.

- 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: SiteManager (September 2007), 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 are 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 100 of these small applications.

According to the Information Systems Director, the department in conjunction with OIR is in the process of "migrating" its application systems to the state's data center. The department's data security increases from having its applications run in the same secure environment as the state's other applications. The director estimated that the process of

transferring all critical systems to the data center would take at least a year. In addition, the director stated that as noted in the prior year's "Management's Comment," the long-term solution for the department would be the establishment and periodic testing of an "alternative recovery site," which he estimated would be constructed by the state within two years. The "alternative recovery site" would be for all of the state's applications run by OIR, not just the Department of Transportation's systems. If a problem should occur at the primary site, the "alternate recovery site" can be used in the event of a disaster without a significant delay in reestablishing computer operations.

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

As noted in our prior recommendation, the Commissioner of the Department of Transportation should ensure that a disaster recovery plan is fully developed and implemented for these in-house applications considered vital to the department and the state. Management's action should include following through with its plan to "migrate" its application systems to the state's data center. 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 continue to include the risks noted in this finding in management's documented risk assessment and reevaluate the mitigating controls identified in the plan for adequacy and completeness. The Commissioner should ensure effective controls are in place with respect to disaster recovery and assign staff to be responsible for ongoing monitoring of this risk and the progress until completion of the plan. After the disaster recovery plan is completed, staff in the Information Technology Division should periodically review, test, and update the plan for changing conditions.

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. As a result of these findings, TDOT has undertaken a concerted effort to more clearly analyze our Disaster Recovery (DR) needs and establish a comprehensive plan to address them.

TDOT backs up all of its systems nightly and stores them off-site with the state's backup vendor. Should there be any server failure or database corruption, backup files are retrieved promptly and the disabled application/database is restored to full working order. Likewise, TDOT retains spare servers on-site should the failure be caused by faulty hardware and require equipment replacement.

However, as the findings describe, this department acknowledges its risks should a more catastrophic event occur such as the loss of TDOT's computer room and/or inaccessibility to its computer room. Triggered by the Comptroller's findings, one of the first tasks to be undertaken was the development of a complete inventory of all TDOT systems. This has been accomplished.

The next initiative is a thorough Business Impact Analysis (BIA) which is currently underway. The BIA is targeted for completion in this calendar year. The BIA report will identify the maximum number of days for each system that it can be inoperable without having an undesirable effect on TDOT operations. This report will be used to establish priorities for addressing the migration and DR requirements of all other TDOT systems.

Early on in the BIA study, it was imperative to identify those systems that are considered highly critical to the daily operations of TDOT. It became evident that two systems stood out as being of such operational significance to the department that prompt attention must be given to their DR needs. These two systems are TDOT-STARS and the Tennessee Overweight/Overdimensional Permitting System (TOOPS).

TDOT-STARS is a mainframe-based system that has a well-established disaster recovery plan. TOOPS is currently being migrated to the state's data center and is scheduled for completion on or before December 2008. Once this system has been successfully migrated, the disaster recovery plan for this system will be completed as well. TDOT will retain the TOOPS current operating environment in its computer room to serve as its alternate recovery site.

After the Permitting System is migrated, TDOT will utilize the results of the BIA to prioritize its continuing efforts, in partnership with OIR, to migrate its remaining systems to the State's data center (providing a safer server environment and mitigating current risks). Based on each system's level of criticality, a project plan will be created to identify target dates for migration and updated disaster recovery technical documentation. During this migration initiative, TDOT IT will retain its existing computer room to serve as an alternate recovery site for these remaining TDOT systems.

TDOT will work closely with OIR as they construct two new data centers with disaster recovery and fail-over capabilities for the State as a whole. Once these new data centers have become operational and their DR capabilities are fully functional, TDOT will no longer have a need to retain and maintain its own computer room.

The Tennessee Department of Transportation is fully committed to this and will continue its efforts to accomplish the above described objectives as quickly as possible and targeted to be completed within the next 2-3 years.

2. <u>As stated in the prior audit, the department did not always comply with OMB Circular A-133 regarding the monitoring of subrecipients, increasing the risk of the department not detecting fraud, waste, abuse, and noncompliance problems with subrecipients</u>

Finding

As stated in the prior audit, the Department of Transportation did not comply with certain Office of Management and Budget (OMB) Circular A-133 provisions regarding subrecipient monitoring for its subrecipients receiving Federal-Aid Highway Program and other federal funds. The department has resolved the parts of the prior audit finding related to notifying subrecipients of applicable CFDA [*Catalog of Federal Domestic Assistance*] numbers in the award document and monitoring the required number of subrecipients. However, we found that the department did not issue management decisions on audit findings within six months after receipt of the subrecipient's audit report, and the department did not ensure that subrecipients pursued timely and appropriate corrective action on all audit findings.

OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* establishes requirements for the monitoring of subrecipients receiving federal monies from a pass-through entity. Part 3 of the OMB *Circular A-133 Compliance Supplement* states:

> *Subrecipient Audits* – (1) Ensuring that subrecipients expending $500,000 or more in Federal awards during the subrecipient's fiscal year . . . as provided in

> OMB Circular A-133 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.

We tested 25 subrecipients with the largest amount of federal expenditures for the federal fiscal year ending September 30, 2006, to determine if the department was in compliance with the subrecipient audit requirements of OMB Circular A-133. All 25 subrecipients were audited as required by OMB Circular A-133. However, our testwork disclosed that of the 25 subrecipients tested, 3 subrecipients had findings concerning grants for which the department served as the pass-through entity. The audit reports for the remaining 22 subrecipients did not have findings. We found that for three findings tested for these three subrecipients (100%), DOT management did not issue a management decision on the findings or follow up to ensure subrecipients took timely corrective action as required by OMB Circular A-133. Since this has been brought to their attention, management has taken steps to follow up and issue a management decision on these findings. The Management's Comment from the prior-year finding stated that "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."

Based on inquiry and observation, we found that the responsibility for complying with these requirements is not clearly assigned to a specific person or division. For example, the department has financial monitors that monitor the department's subrecipients. While reviewing the financial monitors' reports, we observed that although one of the financial monitors had identified one of these findings in work papers, no follow-up was initiated and ultimately the management decision was never issued or additional follow-up performed. Again, the responsibilities in this area are not clearly defined so that the monitor would know who to contact in the department when a subrecipient audit finding is detected to ensure the subrecipient pursued the required corrective action. The External Audit Director, who is also in charge of subrecipient monitoring, informed us that this was the responsibility of the individual program areas, and the Director of Accounting reiterated that this was his understanding as well. However, our review of the program areas indicated that the areas were not performing this duty. The department does not have written policies and procedures clearly assigning these responsibilities to specific staff.

The Department of Transportation serves as a pass-through entity for the Federal-Aid Highway Program and other federal programs. During the fiscal year ending September 30, 2006, the 25 DOT subrecipients tested had federal expenditures in excess of $80 million. When the department does not exercise proper oversight over subrecipients, there is an increased risk that problems including fraud, waste, abuse, and noncompliance by subrecipients will occur and not be detected and handled appropriately in a timely manner by the department.

Recommendation

The Commissioner should ensure that policies and procedures are developed and implemented which clearly assign the responsibilities for reviewing subrecipient audit reports for findings, issuing management decisions for any findings noted, and ensuring that subrecipients pursue timely and appropriate corrective action on all audit findings. In addition, these procedures should include a process where financial monitors know who to contact in the department if a subrecipient audit finding is detected during the monitoring process. Management also needs to identify staff to be responsible for the ongoing monitoring for compliance with subrecipient monitoring requirements. Management should continue to include the risks noted in this finding in management's documented risk assessment.

The Commissioner should also continue to ensure that other risks of improper accountability, noncompliance, fraud, waste, or abuse related to subrecipient monitoring are adequately identified and assessed in management's documented risk assessment. Management should implement effective controls to ensure compliance with applicable requirements and should 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. By March 31, 2008, we will revise our procedure for the review of A-133 Audits and the follow-up on findings. We plan to utilize the Comptroller's Data Base on grantees which are required to have an A-133 Audit and on February 20, 2008, we requested a report of grantees expending $500,000.00 or more in Federal Funds. This information will be compared to our own internal list of grantees to determine grantees for which an A-133 audit is required.

The Detailed Review Guide (DRG), which monitors use in their review of grantees, will be revised to include guidance when findings are found in a grantee's audit. Also, when findings are discovered, the Finance Office will notify the Program Contact and the Director of the Program Area. Jointly, a determination will be made as to the appropriate actions to be taken concerning the finding.

3. <u>The controls over the Formula Grants For Other Than Urbanized Areas program were weak, increasing the risks of the improper use of funds and the misappropriation of vehicles</u>

Finding

The department's controls over the Formula Grants For Other Than Urbanized Areas (Formula Grants) program were weak. The Formula Grants program provides financial assistance for public transportation services to nonurbanized areas. The program's functions are carried out by the Division of Multimodal Transportation Resources. Allowable expenditures for

Formula Grants funds include operating and administrative costs and the acquisition, construction, and improvement of facilities and equipment. Our testwork disclosed the following problems relating to lack of approval, segregation of duties, and vehicle management:

Lack of Approval and Segregation of Duties Over Payments to Subrecipients

A Request for State Reimbursement form is used by subrecipients to request reimbursement from the state for expenditures incurred while performing program functions. We tested 76 Request for State Reimbursement forms that we selected as significant items totaling $11,490,614.99. We found the following problems:

- For 42 of the 76 Request for State Reimbursement forms tested (55%), program staff did not properly approve the request forms for payment. For 33 of the 42 request forms tested, interns employed by the department approved the forms for payment, but interns were not authorized to approve the forms. For the remaining 9 request forms, there was no approval signature.

- The division's management did not adequately segregate duties of employees responsible for authorizing payments to subrecipients during the audit period. For 32 of 76 Request for State Reimbursement forms (42%) tested, the same employee approved the Request for State Reimbursement form and approved the DT-0600 (Department of Transportation) form. The DT-0600 form is used by the department's finance office to initiate payments to subrecipients for program expenditures. In addition, the DT-0600 form has separate lines for an employee to sign off as the person performing the "Coded By," "Approved By," and "Entered By" functions. We also noted that of the 76 DT-0600 forms tested, no employee completed the "Entered By" line on 9 forms. The division's program manager who approved the Request for State Reimbursement forms also prepared the subrecipient's contract from the subrecipient's application, served as the main contact person at the division for the subrecipient, and performed the required program monitoring. It is important that another employee also approve the payment to ensure proper segregation of duties so that more than one employee is monitoring the subrecipient's expenditures and compliance with the contract. When the division's procedures for segregation of duties are ignored, there is an increased risk that improper payments may occur.

The department paid subrecipients $13,514,540.99 for the audit period ending June 30, 2007. Based on our testwork on the reimbursement payments, although division staff did not always follow the approval process, the reimbursements were for appropriate program expenditures.

Inadequate Oversight of Subrecipient Vehicles

The Division of Multimodal Transportation Resources uses Formula Grant funds to purchase vehicles for subrecipients who provide transportation services under the program. We reviewed the division's controls over these vehicles including the procedures for safekeeping

vehicle titles, the recordkeeping procedures for the required inspections performed by division staff, and the process of staff reviews of vehicle records submitted by subrecipients. In addition, we performed testwork on all vehicle purchases and disposals by program subrecipients for the fiscal year ended June 30, 2007. We noted the following problems:

- The *State Management Plan* states that "TDOT [Tennessee Department of Transportation] staff conducts an annual inspection of all vehicles and other capital equipment purchased and/or operated with Section 5311 funds. All vehicles are inspected and photographed. TDOT maintains a computerized inventory of all Section 5311 equipment." However, according to the Assistant Director of Program Operations, the division's staff did not conduct an annual inspection of all vehicles for the fiscal year ended June 30, 2007. Per discussion with the Assistant Director and a Transportation Specialist in the division, the inspection was not completed for the fiscal year due to an employee not performing his job duties properly. The employee's duties have been reassigned.

- The division's staff did not perform the reconciliation between the division's vehicle records including vehicle titles and the computerized inventory mentioned above and the inventory control report submitted by subrecipients for the fiscal year ended June 30, 2007. The division requires subrecipients to submit vehicle titles to the division when vehicles are purchased. In addition, the department's contract with the subrecipient requires the subrecipient to submit the inventory control report. The division staff should perform the reconciliation between these records to ensure that the subrecipients are properly reporting all vehicles as required.

- The division's staff did not maintain complete records of vehicle purchases and dispositions by subrecipients for the fiscal year ended June 30, 2007. Our review of the division's records revealed 10 vehicle dispositions that were not included in the listing of vehicle dispositions provided to us by the division's staff for the audit period. In addition, three vehicles purchased by subrecipients during the audit period were not included on a listing of purchased vehicles provided to us by the division's staff. According to discussions with the Transportation Specialist, these records were also the responsibility of the employee discussed earlier whose job duties have been reassigned.

- We found that 18 of 56 vehicles that were disposed of during the audit period (32%) were still listed on the active inventory listing submitted by subrecipients. The division's staff had not detected these differences because the proper reconciliation discussed above was not performed.

- In addition, the division's staff did not obtain a capital asset inventory form for 8 of 56 vehicles that were disposed of during the audit period (14%). Subrecipients who sell their vehicles for more than $500 are required to prepare the capital asset inventory form which includes the sales price and submit the form to the division. The department's contract with the subrecipient requires proceeds from the sale of vehicles to be used as the subrecipient's required match for capital and/or operating

expenses. Without this form, the division lacks the information to properly determine whether the proceeds from the sale were properly applied as matching funds.

As a result of the problems with vehicle oversight noted at the department, we visited three subrecipients. Our procedures included reviewing the subrecipients' vehicle inventory procedures, observing the inventory records, and observing vehicles. Other than the problems noted above, no further problems were noted during our visits to the three subrecipients.

Based on interviews, inquiries, and testwork performed, we determined that the deficiencies noted above were primarily due to a lack of segregation of duties, inadequate or nonexistent policies and procedures, and weak oversight by management. While performing our procedures, we learned that the Commissioner was already aware of problems in this division and had taken certain actions to correct the problems. These actions included the Commissioner appointing the new Director of Operations, who had already begun restructuring the division by replacing key employees in the program area and implementing new policies and procedures.

When program controls are weak, there is an increased risk that program objectives will not be realized and that assets of the program, including vehicles, may be improperly used or misappropriated. In addition, weak controls increase the risk that problems including fraud, waste and abuse, and noncompliance by subrecipients will occur and not be detected in a timely manner by the department.

Recommendation

Management should continue to be proactive in implementing new policies and procedures and ensuring that existing employees are held accountable for actions detrimental to the program. Management's actions should include steps to ensure:

- that division management properly segregate approval duties for all expenditures and prepare written procedures concerning who can approve expenditures for payment and initiate the process for reimbursement by the department;

- that division staff reconcile departmental vehicle inventory records with records submitted by subrecipients and accounting for any discrepancies and ensure that subrecipients submit the capital asset inventory forms as required; and

- that division staff conduct an annual inspection of all vehicles and ensure that all vehicles are inspected, photographed, and maintained in a computerized inventory.

The policies and procedures established by management should clearly assign responsibilities to a specific person or division. Management also needs to identify staff to be responsible for the ongoing monitoring for compliance with all program requirements. Management should include the risks noted in this finding in management's documented risk assessment.

The Commissioner should also continue to 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 should 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. On July 1, 2007, the workflow structure of the division operations was restructured and the requests for state reimbursements duties were segregated. The program management, contract and financial management roles have been separated and other controller and compliance functions have been established that did not previously exist.

The inspection of vehicles has been made a responsibility of the newly established Compliance Section. In addition, the State Management Plan was revised to show that the retention of vehicle titles is not a federal requirement and has been approved by the Federal Transit Authority (FTA).

STATUS OF PRIOR AUDIT FINDINGS

State of Tennessee *Single Audit Report* for the year ended June 30, 2006

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 Findings

The current audit disclosed that the Department of Transportation has corrected the previous audit findings concerning compliance with the Copeland Act and incorrectly recording the same capital assets in the accounting records in multiple years.

Repeated Audit Findings

The current audit disclosed that the Department of Transportation has not completely corrected the previous audit findings concerning the development of a disaster recovery plan for certain system applications and compliance with OMB Circular A-133 regarding the monitoring of subrecipients.

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.